Spare the Business, or Spoil the Returns

FOUNDERS CAPITAL MANAGEMENT
2018 ANNUAL REPORT

An innovative money management firm investing in publicly traded equities and fixed-income securities. A deep base in business management with a truly global perspective. A drive to identify true fundamental value. A commitment to buy carefully and hold for the long term. A passion to provide customized investment solutions tailored to each client's financial goals and risk tolerance.

This is Founders.

Founders Capital Management, LLC

2018 Annual Report:

"Spare the Business, or Spoil the Returns"

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PRINCIPALS' LETTER
From: Founders Capital Management

2018: "Spare the Business, or Spoil the Returns"

"If your actions inspire others to dream more, learn more, do more, and become more, then you are a leader."

—John Quincy Adams

Market volatility ruled this year, with many investors deciding to sell stocks and stand on the sidelines until market stability returns. Unfortunately, many individual investors do not view their holdings as property to be held for the long term. Once faced with volatility, they ignore the businesses that underlie their portfolios and only notice the daily price movement. As volatility continues, angst builds— the businesses are ignored, securities are sold, and future returns are eventually spoiled. During uncertain times, it is important for investors to spare the business and refrain from selling their valuable assets. Giving up valuable property during short-term uncertain times only leads to spoiled future returns, since the investor rarely gets back into those same businesses— that have a more certain future—at the same prices at which they were sold.

Investors should remain focused on the business properties they own, consistently evaluating the company's position in the marketplace, as well as the leadership and management that is attempting to create long-term value for owners. Assessing leadership and management of a business is extremely important as part of the investment process, as these attributes have become more important and have drastically changed and over the years—some companies have been far more successful than others in adapting to this transformation.

Why have leadership and management styles changed in business, and where are they going in the future? The answers to these questions are important as company culture is developed around the basic approach to managing and leading individuals—and the right culture sets the stage for future business success.

* * *

2018 can be referred to a year of absorption. After several years of marvelous returns (in 2016 and 2017, the S&P 500's total return was 12% and 21.8%, respectively), the S&P 500's total return was negative in 2018. Despite continued economic growth, the S&P 500's total return fell 4.38% the past 12 months. Of course, with the recent setback in market returns, we received several phone calls from individuals questioning our position in the stock market.

We understand the question, borne of angst from (un)popular political and economic headlines. The market impact of Brexit and Italian financial pressures in Europe; challenges in the Middle East; rising interest rates (blame the Federal Reserve); and trade skirmishes between America, our North American neighbors, Europe, and China are just some of the concerns that plagued investors in 2018.

On deeper reflection, these factors may or may not contribute to future economic (and market) disruption, and citing these events as reasons for certain future setback in the market is likely not accurate. In our view, the market's long-term returns will ultimately be tied to the global economy, and we still see favorable economic conditions for the foreseeable future. We understand that economic activity sometimes outpaces market gains, while at other times the reverse occurs, with market gains outpacing economic growth. We also understand

that pundits attempt to forecast market returns through “leading” or “lagging” economic indicators. It is our belief that their forecasts are likely to be incorrect more than 50% of the time—and so it does not pay to forecast future market prices based on current political or economic circumstances, or on anticipated political and economic activity that no one can truly predict.

Nevertheless, articles continue to appear that prognosticate upcoming market and economic upheaval—for example, the cover story published in *Barron’s* June, 2018 issue, “Why the Bull Market Could End in 2020.” This type of ongoing “noise” causes uneasy investors to contemplate removing their money from the market before the “inevitable setback.” As everyone waits for the market to fall off a cliff, paradoxically, any negative news increases worry and triggers a desire for market participants to rush for the exits, selling valuable properties at any price. The key issue is the pervasive worrying, regardless of what is actually taking place within the companies individuals own. Worry is a result of fear, and fear is a result of uncertainty—so it is important to wrap our minds around what is *certain.*

We stated in previous annual reports that, during periods of macroeconomic and political uncertainty, the barrage of negative news coverage about impending macroeconomic and political risks increases our human inclination to “tune-in,” creating a negative feedback loop that makes many people leery of participating in the markets. Amid rising uncertainty, the question looms: Should I maintain a market position, or should I sell my positions and place money in the bank (earning low interest)—and attempt to “time the market” by waiting for an eventual setback, then re-enter the market at its low, when things look more certain? In other words, should my strategy be to own stocks in a rising market, and move to cash or cash equivalents before the market falls?

We answer the “stay in or get out of the market” question every year, and we will repeat *with absolute certainty* what we have stated in the past: We are not aware of the existence of *any* accurate near-term macroeconomic or market forecast, we cannot predict the eventual impact of unforeseen events on the market, and the chance of someone correctly timing the market is near 0%.

In 1994, University of Michigan Professor H. Nejat Seyhun published a study, “Stock Market Extremes and Portfolio Performance.” Although this study is 25 years old, its findings are insightful and remain relevant:

> *Between 1926 and 1993, more than 99% of the total dollar returns were “earned” during only 5.9% of the months.* ***For the 31-year period from 1963 to 1993, 90 trading days accounted for 95% of the market gains.*** *The implications of this study could well be critical for the average investor. By being “out of the market” for as few as even one or two of the best performing months or days over several decades, a portfolio’s return is significantly diminished.*

So, what do we know with certainty? We know that the global economy continues to grow at a steady pace and that the market will likely be worth more 10 years from now than it is today. Given these facts, we remain focused on the long-term growth of our businesses in a global economy, their underlying strategies, their growth in market share, and their improving positions within their respective industries—as opposed to focusing on what is happening with overall stock prices due to economic or political forecasts that are certain to be wrong.

We believe that we remain on the path of prosperity, yet we recognize that there will always be events that cause hiccups along the way. If negative events were predictable, investors would rationally steer away from any activity that would cause them harm. Most of these events are unforeseeable, however, and we understand that it is human nature to try to forecast what the future may hold. Our view of the future is positive—based not on political considerations or on a prediction of the market’s future price movement, but rather on the prospects for the great companies we own that constitute the Founders portfolio.

The theme of our 2018 letter is “Spare the Business, or Spoil the Returns,” and our topics include:

- 10 Years After the Economic Crisis
- How are Leadership, Management, and Culture Defined Today?
- What Corporate Structure Works in Business?
- Business Gamble, Business Rental, and Business Ownership: The Difference and the Trend
- Mistakes

10 Years After the Economic Crisis

> **"History doesn't repeat itself, but it often rhymes."**
> ***—Mark Twain***

It has been 10 years since everyone stood in shock as the market plunged more than 45% within 180 days. A decade later, the financial crisis of 2008 is still fresh on investor's minds—and rightly so. The sting of the housing crisis was real, as investors who assumed that American home prices could never fall—having never fallen since the 1930s—piled onto the action of flipping homes and/or the subprime mortgages that underlay these real estate assets. Everyone made money—until everyone lost money. In an ironic twist, hedge funds that made money by betting against the housing boom (via shorting subprime mortgages) experienced the greatest influx of investor funds after the crisis. According to a September 8, 2018 *Wall Street Journal* article that reviewed the crisis a decade later, after gathering new money from investors following the crisis, the same hedge funds that had outperformed the markets 6.6 percentage points per year from 1997 to 2009 have since lagged the market by 10.4 percentage points per year.

What is on everyone's mind is the next crisis: What will cause the next significant market downturn? And, when will it happen? Predictably, on the 10-year anniversary of the financial crisis, experts are being asked these questions. Surprisingly, their prevailing opinion is that the next crisis will not spring from political uncertainty or from trade skirmishes with China, Europe, and the rest of North America (although a prolonged trade battle is a potential economic risk). The majority of pundits believe that the next crisis is likely to emerge from a disorderly withdrawal of central bank support, which has been propping up the world economy by injecting trillions of dollars of liquidity into the markets since 2008. The U.S. Central Bank, European Central Bank, and Bank of Japan increased their combined balance sheets from $4 trillion in 2008 to $15 trillion in 2018. According to experts, central bank support through quantitative easing (i.e., introducing new money into the money supply via large asset purchases) ignited a bull market, re-inflating assets to higher levels than before the 2018 crash. The reverse action—quantitative tightening (i.e., removing this money from the system) could cause financial disruption.

Our view is that central banks are well aware that removing money too quickly from the financial system could lead to another crisis—thus, the Federal Reserve is acting in a slow and flexible manner to avoid creating a "market problem." For example, the Federal Reserve continues to raise interest rates in a moderate, methodical manner and allow securities to mature to carefully shrink its balance sheet. We place a low probability on the next crisis emanating from central banks and remain confident in their ability to remove money from the financial system without triggering a market meltdown.

We also don't think the stock market is overvalued. Pragmatically, the projected 2019 earnings on the S&P 500 is expected to be $168, with the S&P 500 trading at 2,507 at year-end. This represents a 6.7% earnings yield ($168/2507) and is not too far from the historical normal stock market earnings yield of 6.25%. In other words, the stock market is trading at a slightly less-then-normal historical range at the beginning of 2019, and is valued as if the 10-year U.S. Treasury bond were also at its historical average yield of 6.25%. However, the year-end 2018 10-year U.S. Treasury bond yield was 2.68%, representing a large disparity to today's 6.7% stock market yield. The logical conclusion is that stocks are better than fairly historically valued, while the U.S. Treasury bond (and nearly all fixed-income instruments) are overvalued given their large yield disparity from historical norms. The danger remains in the bond market due to rising interest rates negatively impacting the value of bonds (perhaps severely)—yet a large majority of investors continue to place a disproportionate share of their wealth into the fixed-income market out of a fear of equities.

This discussion difference between yields from stocks vs. the 10-year U.S. Treasury bond brings us to another traditional investment tenet that we challenge: As a rule, money magazines and traditional advisors suggest a portfolio allocation between stocks and bonds based on one's age. The method most experts today use to determine the percentage of portfolio allocation to be placed in stocks is 120 minus your age, with the remainder placed in fixed-income instruments. Although we respect the attempt to apply a systematic formula to portfolio allocation, we would not suggest using this approach now. Why? Conventionally, the 10-year U.S. Treasury rate has been used as a benchmark when evaluating fixed-income returns. As we mentioned previously, over the past decades, the 10-year U.S. Treasury rate has averaged 6.25%, while the earnings yield on stocks has also averaged 6.25%. This is why the stock market normally trades at 16 times earnings—it is the inverse of the average 10-year U.S. Treasury rate (1/6.25%). The 10-year U.S Treasury naturally serves as

a risk-free investment alternative. On average, stocks may return a 6.25% earnings yield, but most companies retain a large portion of their earnings to invest in their future growth and, therefore, stocks normally outperform bonds over the long term.

Under "normal circumstances," when stock and bond yields are perfectly symmetrical, the aforementioned traditional formula for portfolio allocation may be viable. We are not in normal times today, however. As we stated previously, the stock market (the S&P 500)'s earnings yield at the end of 2018 was at 6.7%. Again, this means that at this point in time, the stock market is trading at a normal historical range and is valued as if the 10-year U.S. Treasury yield is also around 6.25%. The issue is that, in reality, the 10-year U.S. Treasury rate of 2.68% at this point in time is more than 50% below its normal historical rate. We know that the Federal Reserve intends to increase interest rates over the upcoming year(s) and, as interest rates rise, this puts tremendous pressure on bonds, pushing their prices down.

In previous annual letters, we shared our thoughts about fixed-income instruments (and we will repeat these at the end of this year's letter as well). We have written about how bonds have been a "bad deal" and will likely continue to deliver a poor return in the future. If we had applied the traditional formula to our portfolio allocation, we would have been cutting the returns on every dollar we intrinsically received from stocks in 2018 by more than half. Obviously, applying the traditional formula of stock allocation at this time is likely to lead to poor results.

We understand that the stock market's gyration creates angst, but the odds heavily favor stocks, which will continue to outperform bonds until the yields on these two investment vehicles eventually converge. To be clear: We wish to emphasize that we are not against investing in bonds in concept, but we are concerned about a heavy allocation of funds to fixed-income instruments today. In the future, if bond rates rise to a more normal level compared to stock yields (e.g., greater than 6.25%), then we believe we can re-evaluate a reallocation of equities to fixed-income instruments among our portfolios.

So, what will cause the next significant market downturn? And when will it happen? We are uncertain of how and when the next crisis will occur, and 100% certain that we would fail if we attempted to provide a reliable prediction. But here is what we know with certainty: The next crisis will emerge from circumstances that most of us will fail to recognize. It's not what you do see that's the problem—it's what you don't see.

For example, let's consider a situation that many may not see unless they are involved in the financial industry. When looking for cautionary signals in the markets, we seek several broad catalysts that could lead to a crisis, including increasing complexity, interconnectedness in securities, and an aggregation of tightly coupled assets held by a limited number of participants.

During 2018 the amount of trading undertaken on the New York Stock Exchange by computers has now risen to 60%. This computer trading, which has doubled over the past five years, mostly occurs as high-frequency trading—a trading platform that uses powerful computers to transact large security orders at fractions of a second. Complex algorithms are used to analyze multiple securities trading in the market and execute orders to earn fractions of a cent—but the money adds up for these quick market intermediaries. As a result of this trading practice, J.P. Morgan recently stated that only 10% of its stock trades are now completed by regular stock pickers.

In addition, over the past five years, the number of exchange-traded funds (ETFs) and passive investment vehicles has grown to more than 5,000 worldwide—now equaling the number of stocks on the U.S. stock exchanges. Given their explosive popularity, a brief review of ETFs is warranted.

Exchange-Traded Funds (ETFs)

An ETF is an investment fund that trades on the stock exchange, much like a stock. Large investor groups called "authorized participants" (think: banks and brokerage firms) purchase shares of stocks—let's say in the energy sector—and deliver them to the ETF company, eventually turning around and selling ETF shares to investors on the open market. In essence, an ETF replaces the need for an individual to purchase a group of stocks within a sector and offers the investor exposure to a particular area through the stocks held within the ETF. When originally developed, ETFs represented a viable alternative for investors who desired exposure to a particular sector but did not have time to research individual companies.

Of course, what starts out as a good idea on Wall Street often ends up a not-so-good idea. Since investors are always on the lookout for an edge, a plethora of ETFs have emerged to meet investors' appetite for diversification within a given asset class. Initially, ETFs held assets such as stocks and bonds. Today, investors

can purchase just about any ETF imaginable—multi-factor ETFs, single-factor ETFs, derivative ETFs, leveraged ETFs, currency ETFs, commodity ETFs, etc. In other words, if you can package the asset, Wall Street will put it into an ETF—and generate more fees.

What investors don't understand is that, oftentimes, the assets within ETFs are not the actual securities, but derivatives (a derivative is a contract between two parties that derives its value/price from an underlying asset. The most common types of derivatives are futures, options, forwards and swaps.) In these instances, derivatives are potentially used because—in the case of commodity ETFs, for example—the fund does not wish to receive and store agricultural products such as corn and wheat; or perhaps because it may be difficult for the fund to purchase the actual securities the ETF comprises. What does this amount to? Individuals are wagering on the movement of certain assets without ever actually owning them. The problem? Most of these investors are unaware of this fact!

ETFs also figure prominently into the high-frequency trading on Wall Street. For example, high-frequency traders have developed algorithms to identify a price discrepancy between an ETF and its underlying securities. When the ETF price is higher than the value of its basket of securities, the high-frequency trader sells the ETF and buys the underlying securities, and vice-versa. This practice of locking in a profit between the disparity in value and price of a security—called arbitrage—contributes to the exponential increase in Wall Street trading.

Many ETFs are now trading in the stock market with the same velocity as stocks—nobody wants to hold on to an ETF for the long term. And with the overabundance of ETFs on the market representing just about every asset class, abuse of these funds is not readily understood by investors. The authorized participants that generate ETFs make a lot of money managing the rolling derivative contracts embedded within ETFs—at the expense of investors. These participants also make a lot of money lending out the securities within ETFs to hedge funds that would like to short a stock—one example of this is Tesla. We have to ask what financial value is created by this activity that is unconnected to any economic reality inherent in the assets these ETFs represent.

Wall Street and investors have "moved beyond the boundaries" from the original intention of a normal ETF investment. The result: We now have increasing complexity within the financial system due to interconnected securities that are increasingly traded by computer algorithms that have no relation to taking advantage of value created by businesses. The aggregation of trading among fewer participants creates a tight coupling that could dangerously unwind at a "hair trigger"—literally, at the press of a button.

We wish to emphasize that we are not forecasting that the above scenario will happen—but we are pointing out an area that seems to be undergoing "risk creep" that no one is paying attention to and has led to increased market volatility.

What is important to remember when others go off on tangents and follow the latest investment fad: *Focus*. And remember the two cardinal rules of investing:

- Rule #1: Know *exactly* where your money is, at all times
- Rule #2: Pay attention to the first rule!

This way, if a temporary market tsunami hits, we can be comfortable knowing exactly the underlying securities we hold, and that our assets will remain intact—safe and secure. In other words, knowing and understanding the underlying security provides a life jacket to investors during turbulent economic times. The underlying security is represented by its name: *Security*.

As we know, Wall Street can seem an unsecure place to do business. Unfortunately, Wall Street firms have an incentive to develop products to sell to naïve investors to maximize their fees. Once a particular investment vehicle becomes popular, Wall Street is more than happy to satisfy demand by producing even more complex products to fill investor portfolios while taking money from their pockets. A part of Wall Street is built to prey on the human frailties of greed, envy, and pride.

A side story: There was an investment banker who was approached by two brothers who wanted to make more money than average investors. The banker, interested in satisfying the brothers, told the first brother that, for a 20% fee, he could grant three wishes. However, the banker stipulated to the first brother that the second brother would always make double his returns. The first brother agreed and quickly wished for a 50% return on his portfolio the next year. He got his wish and watched the second brother get a 100% return *(the banker*

walked away with a hefty fee). In the second year, the first brother said he wanted to make $10 million. Poof—at the end of year two, his wish came true, and the first brother watched the second make $20 million *(the banker walked away with a hefty fee)*. The third year, the banker asked the first brother for his last wish. The first brother looked at the second (richer) brother and declared to the investment banker his last wish: "I would like to lose 50% of my money *(the banker walked away with a hefty fee)*. The moral: No matter how much we have, we tend to compare ourselves to others who have more. This drives individuals to abnormal investment behavior, and *the banker always walks away with a hefty fee.*

What is the basic problem with Wall Street and, for that matter, many corporations and investors? Human nature. It seems we are wired to want more—more money, more returns, more happiness, and more certainty. Part of human psychology seems to be that we are never satisfied. Of course, one can argue that extreme excess can be avoided through true leadership, effective management, and setting a culture that includes humanistic values such as caring for one another. A lack of strong global leadership – in both the public and private sectors – can exacerbate an already tenuous situation once it occurs, and this is likely the biggest risk we face today in the economy and the markets.

How are Leadership, Management, and Culture Defined Today?

> **"Leadership is not about being in charge. It is about taking care of those in your charge."**
>
> ***—Simon Sinek***

> **"Management is doing things right; leadership is doing the right things."**
>
> ***—Peter Drucker***

What goes around, comes around: The story of the banking crisis of 1907 pivots on the themes of greed, self-interest, and extreme abuse of trust. More important to recognize in this story are the previously mentioned cautionary signals in the market that can lead to a crisis: Complexity, interconnected parties, and an aggregation of tightly coupled assets that converged and led to panic.

The panic of 1907 began with a stock manipulation scheme to corner the market in United Copper Company, a company owned by F. Augustus Heinze. Heinze had made a fortune as a copper magnate in Butte, Montana, and in 1906 he moved to New York City. He formed a close relationship with a famous Wall Street banker—Charles W. Morse. (Morse was a well-known speculator who had once successfully cornered New York City's ice market.) Together, Morse and Heinze gained control of many banks, and the two collectively served on the boards of six national banks, 10 state banks, five trust companies, and four insurance firms.

Heinze had a brother, Otto, who devised a scheme to corner United Copper Company stock. Since the Heinze family already controlled a majority of the company, Otto thought that a significant number of the Heinze's shares had been borrowed, and sold short, by speculators betting that the stock price would drop further. Otto proposed to aggressively buy United Copper stock and create what is referred to as a "short squeeze." His concept: The Heinzes would aggressively purchase as many remaining shares of United Copper as possible—driving up the stock price and squeezing anybody who borrowed their shares—and then sold them with the intention of buying them back at a lower price, returning the borrowed shares, and making a large profit. Otto Heinze wanted to dash the hope of speculators that were intent on buying United Copper shares back at a lower price and making money—under his "short-squeeze" scheme, speculators would be forced to repurchase their borrowed shares at an extremely high price that the Heinzes determined. The Heinzes stood to make a fortune from the short sellers. Notice the complexity of this transaction—one must read it a few times to understand it.

To finance his scheme, Otto, Augustus, and Charles Morse met with Charles T. Barney, president of the city's third-largest trust, the Knickerbocker Trust Company. Barney had provided financing for previous Morse schemes. Morse cautioned Otto, however, that to attempt the squeeze, Otto needed much more money than Barney had. On hearing the scheme, Barney declined to provide funding. Otto then decided to attempt the corner anyway and, on October 14, through Otto Heinze and Company, he ordered the brokerage house of Gross & Kleeberg to aggressively begin purchasing shares of United Copper, which rose in one day from $39

to $52 per share. On October 15, he issued the call for short sellers to return their borrowed stock. The share price rose to nearly $60, but he had miscalculated, and the short sellers were able to find plenty of United Copper shares from sources other than the Heinzes. Otto had misread the situation, and the share price of United Copper began to collapse. On October 15, the stock closed at $30 and then fell to $10 the next day. After the collapse of United Copper, Otto Heinze & Company reneged on the contract to pay the brokerage house of Gross & Kleeberg for the shares they had purchased on Otto's behalf, forcing them to close their doors and suspend all trading. Now to the interconnected parties and aggregation of tightly coupled assets....

The stock exchange announced the official suspension of Otto Heinze and Company due to its failure to meet financial obligations. When Otto Heinze offered to pay Gross & Kleeberg one-third of the obligation, it was too late—several other brokers had sold off their Heinze accounts to avoid Gross & Kleeber's fate. At the same time, as brokers lined up outside the Heinze offices to collect their checks, the State Savings Bank of Butte, Montana declared bankruptcy. This small bank—which was owned by Otto Heinze's brother, Augustus—had only 6,000 depositors. But the State Savings Bank of Butte also had funds on deposit with the Mercantile National Bank of New York—where Augustus Heinze was president—along with loans of $1 million to various Heinze interests that used United Copper stock as collateral for some of the loans. Since United Copper stock tanked, the collateral was jeopardized, pushing the Mercantile National Bank to disclose its problem and force the resignation of Augustus Heinze as President. The rest is history: Since Augustus Heinze had connections to Charles Morse and other New York banks, depositors began to literally line up outside the banks to withdraw their money, and the run on the banks commenced. The contagion spread to Knickerbocker Trust, where president Charles T. Barney was forced to resign due to his connections to Charles Morse. Knickerbocker Trust had come under scrutiny when Charles Morse was under investigation by New York's Clearing House Committee, which served a critical role clearing checks between banks. Morse had suggested to the committee that they should look at other institutions if they were to complete a full investigation, and Knickerbocker appeared on the committee's radar. This news triggered a full-fledged run on the nation's banking system.

Fast forward: The banking system is saved by J.P. Morgan, who stepped in to develop a pool of money to back the trusts and the failing banking system. Although this worked, and the nation's banking system was saved, the work of the Pujo Committee—a powerful U.S. congressional subcommittee that was formed to investigate the "money trust" put together by Wall Street bankers and financiers that exerted control over the nation's finances—led to the establishment of the Federal Reserve Act, and the nation witnessed the birth of the Federal Reserve System in 1914.

The most interesting part of this story occurred during the investigation, when J.P. Morgan gave testimony. Well-known New York trial lawyer Samuel Untermyer grilled Morgan with questions on behalf of the committee. After hours of questioning, he asked: "Is not commercial credit based on money or property?" J.P. Morgan responded, "No, sir, the first thing is character." Untermyer shot back, "Before money or property?" "Before money or anything else," Morgan quickly replied. "Money cannot buy it, because a man I do not trust could not get money from me for all the bonds in Christendom." The place erupted with applause—recognition that this was the leadership that backed the empire Morgan had built. Character drove his banking behavior, and *character is the essence of true leadership.*

Every year, we give University of Connecticut students a lecture focused on the differences between management and leadership skills needed to build a business. Managing a business requires skill in capital allocation, human resource allocation and capability-building, planning, organization, and execution. Each of these areas contributes to a company's value creation. On the other hand, leading a business requires passion and intensity to achieve goals, fostering competitive intelligence and empowerment among employees, establishing a culture of strong ego (as opposed to big ego), and effectively communicating both inside of and outside of the company. In our effort to characterize strong management and leadership, we find it difficult to fully convey the key differences between these essential qualities – especially leadership – that drive a business forward. Perhaps the difficulty in describing these differences is why many organizations fail in one of these two areas. Following is a summary of the leadership traits we look for in executives that lead and manage businesses we like to own.

Ownership versus Stewardship

Great leaders recognize that their positions are greater than the persons themselves. For example, Lincoln and Churchill regarded themselves as citizen stewards charged with overseeing the security and advancement of their respective great nations during difficult times. Neither thought of themselves as "owners" of their

countries—a trait we find in dictators. Does anyone truly own their family or their house? Is there a true "owner(s)" at Founders? If the idea of ownership is ultimately irrelevant, then the notion of stewardship becomes key. Keeping with the Founders example: As leaders of our firm, we believe that we should act as stewards charged with protecting a value system that has grown through the firm (i.e., value-based investing), along with nurturing a set of values that must prevail for the organization to succeed in the future, including honesty, integrity, adaptability, resilience, acceptance, and an environment of generosity (i.e., understanding and love). We feel lucky to have this stewardship and honored by the privilege. As we undertake our business, we look for leaders of businesses we own to be great stewards of the organization they are responsible for. Ultimately, we look for *character.* As J.P. Morgan stated about character: *"Before money or anything else. Money cannot buy it."*

The Individual vs. the Collective

We believe that effective leaders focus on the collective versus the individual. For example, we do not believe Founders exists to serve its owners. Founders exists to serve its clients as well as its associates, who create value on behalf of all participants. Furthermore, we regard our leadership positions at Founders as temporary. To believe otherwise would be to serve our personal egos and self-worth instead of our clients and associates. After 100 collective years of leadership in business (and in life), we truly understand this distinction and have concluded that life has greater personal meaning in serving others, as opposed to building a memorial to material and/or egocentric success. The collective is what is most important, and the more balanced and connected our ideas and ideals, the better we will perform as an organization over time. It is our strong belief that a collective can be built over time that will provide an environment for Founders to be as successful as other admirable organizations in business. We look for the collective organization trait in businesses we invest in as well.

Inclusion vs. Exclusion

In our experience, it is important to engender an inclusive aspect to Founders, where clients feel in charge of their own money and Founders associates feel in charge of their growth as individuals and contributors to the firm. As leaders, Howard and I could not succeed without the valuable ongoing contributions of Lisa, Ted, and Jeff. Life for clients and associates should always be about choice—the choice to participate in the goals, philosophy, and value system that drives our work at Founders. We like to purchase companies that practice a similar inclusive attitude with their customers, employees, and communities.

Strong Ego vs. Big Ego

Over the years, we have reached the conclusion that ego is necessary for business leadership success. However, we recognize two main types of ego: The strong ego and the big ego. The strong ego accepts responsibility for unexpected occurrences and truly understands that each human being has dreams, goals, challenges, and tribulations. The strong ego leader understands that we are all interconnected, and no one is greater than another—that, in the end, we are all human beings attempting to find our way—including those we think "have it all." Big ego leaders, on the other hand, believe that their desires and needs are paramount—and can even convince themselves that everyone must follow their lead to reach a certain goal. Not true – each of us – including great leaders – must give up something as the environment adapts and changes. For example, at Founders we must evolve the capital allocation responsibilities over time – not too precipitously – within our firm for the organization to become successful in the future. This evolution is necessary as our firm continues to grow. We are more than okay with that, as it is not about an individual person – it is about developing the strong ego among others that is necessary for the organization to succeed. This does not mean sacrificing a guiding philosophy or delegating without responsibility and oversight. Nonetheless, this so-called migration of decision making provides us comfort that the firm will prosper for clients and associates over the long-run.

Passion vs. Compassion

We have a passion for certain concepts at Founders—passion for work and compassion for humanity. We hold to some **"R"** words – **R**esponsibitly (take it), **R**espect (always give it) and **R**esults (strive for excellence). We also believe in some **"L"** words – **L**earn (constantly), **L**ive (for others) and **L**ove (what we do— the opposite is a waste). We believe that many individuals are too focused on the future and "what comes next" (both in business and personal life), failing to understand and appreciate the here and now. Focusing too much on the future is what leads individuals to think that Amazon.com will destroy "all" businesses in its path, or that Netflix will displace "all" entertainment, leaving other companies like Disney in its wake—we shall see.

A Living Culture

The past year at Founders has been difficult due to Jon's passing, and I would like to address the transition within our firm. First, I miss Jon terribly, yet I feel his presence in our firm every day. Eventually, the founders of Founders will pass on—this is inevitable. It is natural to question what will happen when the inevitable occurs. Our answer: Death is the absence of life. While we are alive, if we choose to create a culture at Founders that lacks love and compassion for life (and others), then we are already choosing death for the organization, even though we are technically alive as a firm. Jon and all of us at Founders made a decision long ago to be an organization that constantly pursues self-knowledge and is committed to prepare the firm for the inevitable passing of the leadership torch. We believe there is a universal and dynamic system of love and compassion that rules each of us, and the existence of this has little bearing on being alive or not— thus, as time and death are relative, love and compassion are relevant in any organization. Jon exemplified these traits both internally within Founders as well as externally with clients. In our opinion, all mankind has a desire to be loved and wants to have compassion given to him/her. To have this in our firm, it is necessary for us to give it. This is why Founders decided to write an outline of our organizational culture so that we always remember what we stand for. We are open to sharing this binding document and have provided our firm's cultural outline as an appendix at the end of this annual letter.

What Corporate Structure Works in Business?

During the past 100 years, there has been an ongoing debate about the best type of corporate structure to compete in business. Should a company use a conglomerate structure like General Electric and United Technologies or a more focused structure like Coca-Cola and Home Depot? Should a company have a decentralized corporate structure like Johnson & Johnson and Berkshire Hathaway or a more centralized corporate structure like Proctor & Gamble and Boeing?

Prevailing wisdom about ideal corporate structure has fluctuated over the decades, and we have witnessed the full spectrum. For example, in the 1960s, conglomerates like ITT, Teledyne, and Gulf and Western dominated the markets and were cited as examples of modern corporate structures that would rule the future. All these conglomerate organizations were eventually broken apart into separate companies. Even today, we are witnessing a breakup of conglomerates such as GE, DuPont, and—in the near future—United Technologies.

Our view on corporate structure is like our view on the structure of financial markets. Many pundits point out how the financial markets (and the economy) go through cycles. The thinking is that the financial markets experience ongoing ups and downs over time, based on a combination of economic activity and investor psychology that contribute to the roller-coaster gyrations of the stock market. In fact, a recipe of very positive economic activity mixed with investor optimism drives a large initial upward swing in the stock market that may not be deserved. Conversely, when the economy contracts and investor psychology turns negative, the stock market undergoes a severe drop that is also underserved. Seasoned market professionals understand that swings in the economic and investor psychology pendulums are normal. Based on their experience and expertise, many of these pros attempt to forecast the swings to sell at the top of market enthusiasm and buy at the bottom of despair.

We have monitored the success of this strategy over the past 40 years and can say with certainty that timing the market via forecasting the economy and investor psychology is a failing practice. Predicting the market's sunny days and storms is like forecasting weather. Sunny and stormy days are certain to be experienced, but we don't know exactly when. We don't see the financial markets as a cyclical machine that can be predicted with any degree of probability. Rather, we view the financial markets as a complex living ecosystem encompassing many factors that influence its direction. To illustrate this point, let's equate the financial markets to a rainforest. We can imagine the thousands of animal and plant species that live and strive to survive in the ever-changing rainforest ecosystem. A high percentage of rain feeds the ecosystem as the various species compete for resources. In this competition, all species have a desire for more, but it is during stressful times that Darwinian forces accelerate. Through natural selection, strong species get stronger, and the weak ones perish.

How is a rainforest ecosystem analogous to a financial market ecosystem? In the financial markets, capital is like rain—when capital is abundant and flowing strongly, its rain on the markets allows all participants (i.e., all "species," including companies, governments, etc.) to compete for the expanded financial resources. When capital is withdrawn from the financial ecosystem, however, the monetary "drought" puts stress on all participants, and the competition for a limited amount of money becomes intense. Most times, the capital that

“rains” on the financial ecosystem is steady, and market participants have a more pleasant environment in which to compete for financial resources to grow their domains. Like the rainforest that evolves and shifts over time due to different weather patterns and Darwinian forces driving species adaptation and survival, the natural financial ecosystem is extremely complex and difficult, if not impossible, to predict. Thus, we don’t try to predict market behavior. Predicting that the market will fall over the next five years because stocks have collectively experienced five years of gains is like guessing that the next flip of the coin will be tails because the last five flips were heads—there is always a 50/50 chance, no matter how many prior times tails (or heads) has been flipped in a row.

With this said, we do intensely follow the flow of capital—especially credit expansion or contraction—within the financial ecosystem to see where excesses are taking place. When we see extremes—like the past flow of bank funds into the mortgage market, or the massive flow of capital into ETFs today—we avoid participating in these areas that we recognize may become unbalanced. The current capital flow into ETFs does not mean that the “whole financial system” is now at risk of failure. As we stated previously, we do see a steady flow of capital being removed from the financial system as interest rates rise and bonds mature on the Federal Reserve’s $4.5 trillion balance sheet (up from $900 billion before the 2008 financial crisis). This is normal and to be expected, given the flood of capital that was placed into the financial system after the credit crisis 10 years ago. Overall, we do not see signs of capital stress in the financial ecosystem that would precipitate a systemic credit crisis. But in the event that we are mistaken, we rest assured that our portfolio companies have deep resilience.

Industry Sub-Ecosystem

Not unlike a rainforest, within the financial ecosystem, sub-ecosystems exist where various species—i.e., companies—interact and compete for resources. In a financial sub-ecosystem, companies within an industry compete to survive, grow, and achieve dominance. Also like species within a rainforest, companies are not immune to Darwinian competitive forces—some will flourish, while others will become extinct, never to be seen again. The industry sub-ecosystem is interconnected with the overall financial ecosystem but has its own microcosm of evolution. To grow and obtain dominance, a company must adapt to its ever-changing environment.

This adaptation takes on many forms, including establishing a structure that enables the organization to flourish. Some organizations, for example, decide to adapt to their changing environment by becoming a conglomerate, where the failure or death of one business can be offset by another business within its portfolio. The initial success of a conglomerate organism will have a natural tendency to morph into a much larger conglomerate through the acquisition of other businesses to support its growth and ongoing survival. Unfortunately, the conglomerate structure often eventually fails as the organization becomes too large, disbursed, bureaucratic, and complex to manage—GE is a modern example. Thus, the conglomerate structure outlives its usefulness as the organization grows too large, reaching beyond its original mission to be able to grow and/or survive. In fact, the large weight of the conglomerate can create an anchor around each individual business that threatens their survival—and thus, the conglomerate needs to be broken up for its underlying businesses to survive. It is our experience that this is more the norm for conglomerates than not. Sometimes we find opportunities in owning a conglomerate—not for the diversity of its business make-up, but for the opposite reason: The sum of the individual business parts is eventually worth more than the conglomerate whole, and the breakup unleashes value potential based on the individual companies’ newfound flexibility to flourish and compete within their respective industries. We are agnostic about the conglomerate structure, focusing instead on understanding where the individual businesses fit into their industry sub-ecosystems and how they complement each another. We tend to avoid investing in conglomerates that lack a logical sense of how value is being created unless there is potential for great value to be unleashed through separate focused structures (i.e., a break-up).

Some companies establish decentralized corporate structures, with many related businesses under a single corporate “umbrella” —Johnson & Johnson is an example. Other companies adopt a more centralized corporate structure to compete in their industry, such as Coca-Cola in the non-alcoholic beverage industry. The line between a centralized and decentralized corporate structure can be murky—for example, management at Coke may insist that they are a decentralized organization. But for the purposes of our discussion, J&J is clearly made up of many separate healthcare companies that exist on their own under the J&J umbrella, whereas Coca-Cola’s beverage brands are interconnected with each other and essentially managed together. Our view on a centralized versus decentralized structure is different than most. We view these companies as

organic and, like living organisms, they must breathe in and breathe out—i.e., there are times when it is necessary for a company to grow within its industry by decentralizing the organization to unleash an entrepreneurial spirit at a local level and expand its domain. There are other times when too much decentralization of decision-making and capital allocation causes spending to rise unnecessarily (with all good intentions), and pulling this back by centralizing the structure increases business value. Our overall view is that businesses are organic, like the human beings that run them, and must expand and contract (breathe in and breathe out) to grow and survive.

In summary, nothing is static in the financial market ecosystem or in industry sub-ecosystems. They are all interconnected and make up an extremely complex system that is unpredictable. As an investor, it is important to be aware of the various interconnected systems, but most important to *focus on the activity of each individual business and its position within the industry to evaluate where its greatest opportunities (and threats) exist.*

Business Gamble, Business Rental, and Business Ownership: The Difference and the Trend

Many individuals that invest in the stock market, whether directly or through funds, have a view that their money is being placed on a roulette table with the hope of landing on the right numbers to obtain a profit. Poring through a company's annual report, reading its competitors' annual reports, and studying the company's industry is not very common. Most place their money on a stock because they recognize the company and see the price moving up—they have a "gut feeling" that the stock will continue to do well (i.e., go up in price). We know from experience that this behavior is rarely profitable. Of course, there will always be a story or two about how someone picked the one great stock that went up fivefold, but you never hear about the other nine selected stocks that went to near-zero. We refer to this investment approach as the "business gamble." If an individual views the stock market as a casino, other market participants will cater to that interpretation. In fact, not unlike a casino operator, brokers that sell investment products for a living prey on investors that have this gambling view—they end up fleecing investors without the investors ever knowing it.

Another approach used by many stock market participants involves studying company annual reports within an industry and then deciding which stock(s) represent the best opportunity to make money over a short period of time in that industry—moving on to the next prospect after each stock reaches a "targeted" price point. This approach is not bad, but we call this the "business rental" strategy. This investor does not care about the long-term prospects of the business—only that there is a good chance to make money in a short period of time and then move on to another opportunity. The business renter is like someone renting a car—the car renter may care a bit about the combination of condition and price of the car when they rent it, but the last thing they care about is the condition of the car after they return it. They just want to know that they obtained it at a good initial price, and the car got them from point A to point B. This investment strategy can be somewhat profitable, but many times after a "stock bargain" is secured at a good price, the stock turns out to be a lemon, and the investor stays behind the investment wheel way too long.

The last type of investor is rare—individuals who intensely study various companies in an industry on a regular basis, year-in and year-out. These "business ownership" investors carefully evaluate each company's position in an industry over time, enabling them to recognize when a specific company has a sustainable competitive advantage compared to others. Next, they evaluate company management and how capital is allocated to increase shareholder value. And finally, these investors place a value on the company based on the previous two assessments. Once these investors have developed a stable of companies they would like to own, they wait for the "right price" that will enable them to obtain an estimated return over time. These investors are driven by the desire to become an owner of a great business at a fair price and hold the company for a long period as if it were a piece of property– being comfortable that the value (and price) of the property will increase as the business grows. While most individuals can relate to the concept of being a business owner, their ability to execute this mindset when investing is nearly impossible. Sooner or later, most individuals lose patience when a great company's price stagnates for a period of time and can't help themselves from jumping to another company that they deem to be better, like a bee that goes from flower to flower hoping to pollinate their portfolio with greater returns.

Most investors participating in the stock market today are business gamblers. We mainly operate as business owners, but we admit to being business renters on occasion—sometimes we can't ignore a bargain. We never practice business gambling, knowing that the results are certain to be poor. With all the investment wisdom we

have gained, we have made mistakes and will likely make mistakes in the future. While we endeavor to not make the same mistakes as in the past, we like to own up to our errors and explain our occasional lapses in judgment.

Mistakes

A well-known investor was in a private meeting with the CEO of a small company. The CEO stated to the well-known investor that his company had just gone public and represented a value. He went on to explain how he was eating his own cooking by maintaining a 50% ownership stake in the public company to align his interests with shareholders. The CEO was representing everything he had heard about the type of management this well-known investor liked to back. Expecting a lively discussion about his company (and a possible future investment), the CEO was taken aback when the well-known investor quickly quipped, “Well, at least when you wake up in the morning and look in the mirror, you can be confident that you are pleasing half your shareholders!”

As an investment firm, complete transparency is important to us, and we are not without our market mistakes. Although we place our money alongside that of our clients, we realize that it is not enough when an investment goes south to simply say, “Well, we eat our own cooking” with the belief that our lost money satisfies the situation.

A disclaimer: In the past, we may not have discussed our mistakes in this annual letter as fully as we should have. This was not out of a desire to “push them under the rug,” as we know that everyone “sees” them. It was due to compliance risks associated with talking about companies and returns (both good and bad) around the investments we make. Therefore, we do not discuss individual company or collective returns in our annual letters—we are not allowed to, adhering to strict regulations regarding private investment firms publishing information about investment returns. As we comply with industry regulations, however, we believe clients deserve full disclosure. We feel it is important to openly talk about our mistakes—you deserve an explanation when we make them and should understand why they were made. But most important, we should share what we learned that will enable us to avoid repeating the same mistakes in the future.

On reflection (and we do this a lot), our investment mistakes generally fall into three categories:

1. Selling a great business
2. Not buying a great business when we see it (a mistake of omission)
3. Misjudging the strategic position of a company in an industry facing disruption

Over the past 15 years, we have made mistakes in all three categories. However, there is a fourth category of investment mistakes that we have not made, and intend never to make—a mistake in accounting analysis and failure to detect financial fraud. When reading annual reports and company filings, questionable accounting that results in financial fraud is usually identifiable, so we can avoid this investment error.

In the first category of mistakes, selling a great business leads to multiple errors that may be unseen to our clients. The first error is obvious—the business we sold keeps growing in value while its investment replacement does not do as well as we had expected. This blunder may be compounded if we had to pay a capital gains tax on the investment we sold. Clients may see the sale of a company that produced a handsome profit (a happy circumstance) and witness the replacement company increasing in value (another happy circumstance). But we know from our analysis that a mistake was made—the lost potential for incremental returns on capital previously allocated to our great business that was sold, negatively impacts our long-term investment results.

We refer to our second category of mistakes—not buying a great business when we see it—as a mistake of omission. Again, clients may or may not “see” this, but we do. Apple can serve as an example here – we saw it, but did not commit due to the iPhone representing a large portion of the company’s profits. We thought that competition in the smartphone market would eventually impact Apple. On the other hand, we take comfort knowing that Berkshire Hathaway (our largest holding) owns more than 5% of Apple. When we make a mistake of omission by not investing in a great company, we want to ensure that we don’t make the mistake again. To be clear: We do not consider a mistake in this category to be one where we missed a “high-flying” stock that produces little to no profits that are not sustainable—we deliberately avoid these investments, eschewing speculative behavior in favor of hewing close to our “circle of competence” and our disciplined approach to investing client money. Eventually, high-flying stocks come down faster than they went up—

permanently destroying capital in the process. We gladly avoid the "turkey investment syndrome"—where the turkey feels great as he is taken care of and fed each day by the farmer, only to be shocked the week before Thanksgiving.

By the time we have determined we've made a mistake in the last category—misjudging the strategic position of a company within an industry facing disruption—we usually have not only lost money on the original investment, but also lost out on the opportunity to buy the great business within this same industry at the lower value it was trading at when we made our original investment with a competing company. This third mistake is more common than the first two, and a recent example provides an illustration: During 2013, we believed that cloud computing and the advent of cognitive computing would become prevalent in the future. Since IBM was a leader in the emergence of artificial intelligence—demonstrated live on the gameshow, "Jeopardy," in 2011—we thought IBM was selling at a discount to its value given its future opportunity. We misjudged the strategic position of IBM in the industry and watched other companies like Microsoft (which we own) and Alphabet (Google) race toward this budding technology. This is a case where we may have been right on the industry race but chose the wrong horse(es) to ride. It took us a few years, but we changed our capital allocation and invested heavily into Alphabet (Google)– which should have been executed sooner.

The investment business changes rapidly and has minefields that must be detected and navigated. Our goals are to avoid making large mistakes, learn from smaller mistakes, and improve our methods to avoid making similar mistakes in the future. There are situations that others may consider mistakes, however, that we do not think of as mistakes. For example, if "timing the market" and/or "timing investments" by buying low and selling high is considered good investment strategy, we are apt to disappoint. In our experience, market and investment timing is a fool's game that leads to permanent loss of capital. These are mistakes we will definitely not make.

At Founders, our behaviors are simple. We hold on tightly to our value investing philosophy, and we seek to invest where intrinsic value strengthens over time. We always act with honesty and integrity—there is no other way. Although we are unable to provide an exact answer to questions about any market's near-term direction, the mixed emotional display surrounding the equity and fixed-income markets today continues to compel us to remain agnostic to any market's short-term movements. Instead, we will keep our eyes open for opportunities that emerge in an uncertain environment—and thus, we will remain patient. Given the more speculative behavior taking place in markets, however, we are strongly adhering to one of our favorite quotes:

> **"The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs."**
>
> ***–Warren Buffett***

We are also mindful of the investment environment and will invest with our eyes wide open. We place continued emphasis on our confidence that we have acquired a collection of securities at prices that will provide a fair return over time (despite gyrating markets and higher-than-normal speculation). This includes our investments in *selected* fixed-income instruments that offer a commensurate risk/reward relationship, as well as acquiring interests in strong individual companies through the equity market that are very profitable and possess a wide competitive moat. Our investment activity in all market conditions reminds us of another Warren Buffett quote:

> **"We will continue to price, rather than time, our purchases. In our view, it is folly to forego buying shares in an outstanding business whose long-term future is predictable, because of short-term worries about an economy or a stock market that we know to be unpredictable. Why scrap an informed decision because of an uninformed guess?"**
>
> ***–Warren Buffett***

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MANAGEMENT'S DISCUSSION & BUSINESS UNIT REVIEW

Equity Holdings: 2018 Highlights

The intrinsic value of our aggregate equity holdings increased during 2018. We remain positive about our capital allocations, including expected returns over the next 10 years—despite any short-term economic and political challenges that may arise.

Given uncertain market circumstances, we'd like to reiterate the following points about our core holdings:

- **We are confident in the high character displayed by the leadership of the companies in our portfolio** and believe that the companies are managed in a flexible manner that allows them to adapt in changing times.
- **We believe that we are business partners in actual companies that are focused on increasing long-term profitability,** as opposed to being members of a group of shareholders that are interested only in a rising stock price that is divorced from a commensurate movement in business value.
- **We believe that we own a collection of business that fall into the "valuable" and "invaluable" categories and that their increasing intrinsic business value will be realized over time.**
- **Our invested companies possess business models that are durable, support a long-term competitive advantage in their respective industries, and have earnings capabilities that are predictable and sustainable over the foreseeable future.**

As long-term investors, we wake up each morning knowing that the wonderful businesses we own—Coca-Cola, PepsiCo, United Technologies, CSX, Medtronic, Microsoft, Google, Intel, Berkshire Hathaway, Wells Fargo, American Express, Home Depot, Walgreens, Disney, Liberty Global, and our other holdings—continue to strengthen their long-term enterprises independent of any short-term gyrations in their stock prices.

Following is a summary of business highlights from our portfolio companies during 2018, along with our expectations for 2019.

CONSUMER GROUP

Our primary consumer holdings—Coca-Cola and PepsiCo—continued to grow their global franchises during 2018. Once again, each of these entities reported adjusted organic growth in global sales due to the continued development of their respective franchises. Principally, aggregate reported profits for these combined entities increased around 7.5% in 2018 and is projected to increase 5.5% during 2019. Although consumer-related businesses continue to face challenging economic and competitive conditions as consumer purchasing patterns and tastes change, we are pleased with our consumer group business performance and expect positive results in the future as these entities cultivate their presence in both developed and emerging markets throughout the world.

Why are we optimistic about the long-term prospects of our global consumer franchises—specifically, Coca-Cola and PepsiCo?

1. An estimated 62 billion servings of non-water beverages are served each and every day around the globe. Coca-Cola and PepsiCo supply approximately 2.7 billion (4.35%) of these beverage servings, and their volume grows at ~2-3% per year over time. Although the total consumption of Coca-Cola and Pepsi beverage products equates to around 128 annual servings per person on earth, there is a lot more room for grabbing market share. It is our opinion that these big companies can become much larger in the future as large, emerging markets like China and India continue to develop.
2. Coca-Cola and PepsiCo are not "just carbonated beverage companies." Between the two companies, hundreds of well-known beverage brands are served in more than 200 countries—including water; ready-to-drink tea; and coffee, fruit, vegetable, and sports drinks. If the world desires a new type of drink (such as health-conscious beverages), it is likely that one or both of these companies will offer it—in many

varieties. In addition, PepsiCo is the largest snack-food company in the world, with a global product offering that exceeds its beverage counterpart.

3. Both Coca-Cola and PepsiCo possess vast, impenetrable supplier and distribution networks. For example, Coca-Cola's $50+ billion supply-chain network, established between the company and its principally segregated bottling system, is one of the largest and most complex of any organization on earth. Coke and its 250+ partner bottlers use well over 500,000 vehicles to distribute their beverage products through 16+ million outlets every day (PepsiCo's beverage and snack delivery system shares a similar complexity). These juggernauts' supplier and distribution components may be their most important hidden competitive advantage. When Coca-Cola or PepsiCo introduce a new product, or acquire a complementary brand, they can immediately put this merchandise through their tremendous distribution networks and introduce them throughout the world.

Coca-Cola and PepsiCo occupy our "extremely valuable" business category—enterprises that can grow far into the future and stand the test of time. Their consistent brand development, product diversity, global distribution strength, and unique cultural depth provide investors the ability to forecast the future with a relatively high degree of probability. It is highly likely that each business will substantially penetrate developing markets over the next 10 to 30 years, and the accumulated potential growth of these businesses cannot be fully identified using traditional valuation models—in other words, each of these businesses possesses superior intrinsic value, underscored by their long-term value-creation potential.

Coca-Cola

In 2018, The Coca-Cola Company remained a large holding in our portfolio, and one that we have held since Founders Capital Management was formed. Although Founders is a relatively small holder of Coke's overall stock, we are around the top 500 reported shareholders of this great company. Our ownership profile has grown over the years due not to adding to our position, but rather because of the company's ongoing share repurchase program—net share repurchases were around $1.1 billion in 2018. We point this out to showcase the "hidden" ownership impact of share repurchase programs and how we can continue to obtain a slightly increased share of the earnings of this great company every year.

During 2018, The Coca-Cola Company's overall case volume growth grew at approximately 2%. Over the past five years, case volume increases have remained slower than the annual 4%-5% annual growth achieved prior to 2013. Much of this is due to a negative trend of consumers movement away from sugary, carbonated drinks. This remains a short-term challenge for Coca-Cola, considering its market dominance in the soda category. However, we believe the future is still very bright for this company as a "total beverage business" that possesses a small market share of global beverage consumption. Another short-term impact on Coca-Cola is revenue growth, which continues to be temporarily curtailed by a negative 1% currency headwind and acquisition, divestitures, and a structural impact of 16%. As a result, Coca-Cola's total revenue declined around 10.3% in 2018, to approximately $31.8 billion. When stripping away the negative currency headwinds and one-time charges, however, Coke's adjusted organic revenue increased approximately 4% this past year.

Coke's continuing revenue declines over the past few years make it important to reiterate the dynamics behind the company's reported sales, which also explains the complexity of this business. Approximately 10 years ago, Coca-Cola began working with its bottling partners to develop a business model that served the changing consumer landscape. As consumers' beverage preferences were moving from carbonated drinks to noncarbonated drinks, Coke faced requests from bottling and distribution partners to invest vast sums in their businesses to bottle both types of beverages. (Since the water temperature requirement for producing each beverage is different, additional machinery was needed for developing noncarbonated drinks.)

In 2010, it made sense for The Coca-Cola Company to better control the production and distribution of both types of beverage products to manage the consumer taste evolution. As such, Coca-Cola decided to acquire the North American territories of Coca-Cola Enterprises (the North American bottler and distributor for Coca-Cola products) and make the necessary capital investment to deliver the beverage choices consumers demanded. The upside of consolidating bottling and distribution for all Coca-Cola products in North America was the flexibility Coke gained over the production and delivery systems required for a changing beverage industry. The downside to the consolidation of bottling and distribution was the increased capital intensity of Coca-Cola's beverage business—which has impacted cash returns, even though Coke applied vast sums of debt to

support this acquisition. The result: Revenues increased exponentially with this initial transaction, but profits stayed relatively the same.

Fast forward to today: Coke's bottling system, customer service, and product supply chain share a common technology platform. Now that the required changes to the bottling and distribution business have been completed to meet consumers' diverse and changing tastes, Coca-Cola has decided to restructure its business model and sell back the controlled North American bottling and distribution system to bottling partners through refranchising arrangements. This "reverse move" lowers revenues through deconsolidation but increases the company's financial flexibility by reducing capital intensity. As of the end 2018, Coke has nearly completed the refranchising of its territories that account for approximately 80% of total U.S. bottler-delivered distribution volume. Going into 2019, we expect Coca-Cola to resume its revenue growth and generate incremental owner earnings as the company's capital intensity has lessened.

The repositioning of Coca-Cola allows the company to evolve from a primarily carbonated-beverage company to a "total beverage company" that serves all consumer tastes. Few people realize that The Coca-Cola Company controls almost half of all non-alcoholic brands worldwide, which generate more than $1 billion in annual revenue. In addition, the company sells more than 1,000 varieties of juice drinks including Simply™, Minute Maid®, Fruitopia®, Hi-C®, Fuze®, and Odwalla®. Coca-Cola also still sells beverage brands such as Glacéau Vitaminwater®, Dasani® water, Honest Tea®, and Powerade®. And finally, Coca-Cola continues to expand its beverage business, having acquired Costa Limited in 2018 for $5.1 billion. This acquisition, expected to close in mid-2019, will expand Coca-Cola's global share of the growing tea and coffee beverage category and adds a scalable coffee platform with critical know-how and expertise that will enable Coca-Cola to further penetrate and expand its share of the total global beverage market.

In summary, Coke's currency headwinds, along with its ongoing refranchising program, have temporarily stalled the company's earnings growth the past few years, but we expect this to change. The company will report approximately $2.08 per share in adjusted earnings in 2018, an increase of 9% from 2017. Although per-share earnings have been static since 2012, we expect Coca-Cola to report growth in per-share earnings in the next five years of approximately 8% per year.

Despite the slower volume growth of the past several years, coupled with currency headwinds and a reset of the company's distribution system, we continue to believe in Coca-Cola's long-term growth prospects. Coca-Cola's sustainable properties and economic resources are among the best in the consumer goods industry, if not the best. For example, the business inputs that create value for Coke's shareholders include the strategic placement of property, plant, and equipment around the globe; patents and brands that are virtually impossible to duplicate; supplier and distribution bottling networks that are balanced in a way to maximize customer reach and profitability; a consumer connection that creates loyalty and "stickiness;" and unique business processes—specifically, the segregation and integration of business assets and functions—that provide a sustainable competitive advantage. These represent "the real things" at Coca-Cola.

More than 90% of the world's population recognizes the Coca-Cola brand—its iconic symbol represents a blend of American culture and home-grown national spirit—for example, many individuals in China believe that Coca-Cola is a Chinese company. "Coca-Cola" *(kekou kele)* in Chinese translates to "delicious happiness."

We believe that Coca-Cola is on track to take advantage of the more than 1.5 billion people around the world that are projected to join the middle class by 2030, and that the initiatives Coke is executing will renew the company's volume and revenue growth in the future, while further increasing its intrinsic business value.

We anticipate that The Coca-Cola Company will produce approximately $7.8 billion of cash for shareholders in 2019. Coke currently pays an annual dividend of $1.56 per share, which represents an approximately 3.3% yield, and we believe that the company will increase its dividend approximately 5% in 2019—to around $1.64 per share. Coca-Cola will likely increase its share repurchase program during the next 12 months as the company allocates excess capital to shareholders. The forward dividend and share repurchase program currently provides shareholders an approximately 4% pass-through yield and owner-earnings yield of approximately 4.25% at Coke's year-end price, compared to a 2.68% yield on a 10-year U.S. Treasury Bond. The yields offered by Coca-Cola, as well as future growth projections, provide us an opportunity to achieve long-term returns on an investment in this company.

NOTE: "Pass-through earnings/yield and "owner earnings/yield" should be evaluated by the investor. "Pass-through earnings/yield" is determined via actual cash distributed to shareholders, whereas "owner

earnings/yield" is cash earnings available for distribution to shareholders. Companies may choose to "pass through" extra money to shareholders beyond their cash earnings by issuing additional debt and/or by selling off assets—or they may decide not to pass through all cash earnings, opting instead to maintain a portion of these funds for future investment or to pay down debt.

PepsiCo

We have stated in the past that while PepsiCo may be Coca-Cola's greatest competitor in the beverage space, this company does not have the same business attributes as Coke. Like Coke, PepsiCo owns a stable of diverse brands, but PepsiCo uses a different distribution system and has a different global footprint (PepsiCo has a lower international presence compared to Coke, with approximately 60% of its sales produced in the U.S.) Let's further clarify the differences between these two businesses:

1. PepsiCo's product line is not a mirror image of Coke's—PepsiCo is much more than a pure beverage company, with a dominant share of the snack-food industry. Its mainstay global food and snack business, which represents approximately 52% of revenues, generates more than 60% of the company's operating profits. PepsiCo's snack-food business has an estimated *tenfold* relative global market share advantage compared to its closest competitor, with prospects for long-term future global growth.
2. Due to its more diverse product line, PepsiCo requires a different retail distribution system and supplier network than Coke. For example, PepsiCo uses direct store delivery (DSD) to deliver beverage and snack products to retail stores, where products are merchandised by both employees and bottlers that "dual-display" snacks and beverages for maximum visibility and appeal. For products that are less fragile and perishable and have lower turnover, PepsiCo delivers directly from manufacturing facilities and warehouses to customer warehouses and retail outlets. In addition, PepsiCo leverages synergies when food service and vending sales forces can work jointly to deliver food, snacks, and beverages to third-party food service and vending distributors. As for its supplier network, PepsiCo provides farmers in emerging markets (such as India and China) with a variety of seeds for contract farming that provides farmers access to a ready market for agricultural products such as potatoes and corn, technological application, farm credit, and crop insurance. The contract farming agreements between farmers and PepsiCo for the production and supply of agricultural products (at a pre-agreed price and certain quantity) creates a supplier network that is loyal, growing, and difficult to duplicate. These are valuable assets that are not obvious from looking at PepsiCo's financial statements.

We point out these differences to defuse any notion that there is a large overlap between our investments in Coca-Cola and PepsiCo. In fact, we expect to see these differences widen, and we look for PepsiCo to build on its snack-food stronghold.

Given the continued global challenges consumer goods businesses faced in 2018, PepsiCo's organic revenue growth was slightly above 3% in 2018 (this increase excludes the impacts of foreign exchange translation and acquisitions, structural and other changes). However, PepsiCo continues to increase its return to shareholders, raising the annual dividend 15% in 2018, from $3.22 per share to $3.71 per share. We expect PepsiCo to raise its dividend in 2019 to approximately $3.90 per share, which implies an approximate forward dividend yield of 3.5% at the year-end stock price. In addition, we anticipate that the company will repurchase an additional $2 billion of stock during the next 12 months. This action adds another 1.3% return to shareholders, reflecting a 4.8% forward pass-through yield. In 2019, we expect PepsiCo to earn around $6.00 per share, representing an approximate 6% increase from 2018.

In summary, we like the long-term potential and economics of the beverage and snacks business and think there is a multi-decade growth opportunity for dominant companies in this industry. PepsiCo has a large and growing position in these business segments and will remain a long-term holding in our portfolio.

INDUSTRIAL AND TRANSPORTATION GROUP

Our primary industrial and transportation holdings— United Technologies Corporation (UTC) and CSX Railroad—are unique businesses that we believe will grow as economies develop around the globe. These businesses are somewhat capital-intensive and sensitive to the economic cycle, however, which subjects them to setbacks when tougher economic conditions emerge from time to time. We remain encouraged as the global economic growth continues, and with a renewed commitment to U.S. infrastructure investment, we believe

these businesses will gain further traction in upcoming years. In addition, a future improvement in the European and Asian economies, followed by support for anticipated overseas infrastructure investment, should allow these businesses to make advances over the next decade.

Our industrial group is composed mostly of highly networked, infrastructure-related businesses that are focused on product innovation. Each of our infrastructure businesses offers high-end products and/or services that are extremely expensive to produce and have a slow replacement rate—attributes that normally would be detrimental to a business' profitability. An industrial company such as UTC initially contracts to sell its products at a low profit margin and then strikes high profit-margin contracts to service the products over their long lifespans. Today, strong industrial companies such as UTC are taking their networking capability one step further by providing software that consistently monitors their installed products, which increases customer productivity and efficiency (and loyalty). These tie-in arrangements cement the customer relationship and make it nearly impossible for a new competitor to enter the market. As a result, oligopolies have become the norm in these industries, where two to three competitors tend to dominate. As globalization continues, the consolidation of purchased infrastructure goods is a natural development, with the result that fewer companies are positioned to provide the breadth of products and services customers demand. Thus, the trend is for these industrial companies to become ever more entrenched, expanding their competitive advantage—and profitability.

Our transportation investments in CSX has comparable advantages. For example, it has taken nearly two centuries to build the U.S. railroad infrastructure, and it would take an extraordinary amount of time and capital to create a business transportation system that competes with railroads such as CSX, Union Pacific, and Burlington Northern (which is owned by Berkshire Hathaway). Although the railroad business is capital-intensive, certain attributes make this type of investment attractive in any economic environment. In today's rapidly changing distribution and logistics environment, companies seek to run more efficiently. Moving greater amounts of goods over a fixed-rail infrastructure instead of via higher-cost trucking enables companies to lower costs and achieve large gains in productivity. Since rail transportation is approximately three to five times more fuel-efficient than truck transportation, it is likely that railroads will play a larger role in the transportation of goods throughout the U.S. in the future. The growing use of rail, along with the expansion of railroad services via "double track" (vs. single track) and "double stacking" of containers, will continue to drive an increase in railroad use, revenues, and profits.

United Technologies

United Technologies Corporation (UTC) produces products such as Otis elevators, Carrier air conditioners, and Pratt & Whitney jet engines. Each one of UTC's subsidiary companies has achieved leadership and powerful market entrenchment in its respective area of expertise. The company also has tremendous global reach in each of its business units, and their products are complementary.

We highlight UTC's long-term future that is driven by major trends:

1. An urbanization trend is resulting in the significant growth of large cities around the world, along with an expanding middle class. The urban population is projected to increase by one billion individuals by 2030, and the middle class is expected to double over this same time frame—representing nearly 60% of the global population. These trends drive housing, office-building, and mass transportation needs around the globe.
2. The dramatic growth in commercial air travel positions UTC's Pratt & Whitney subsidiary to benefit from increased airplane engine demand—the number of aircraft in service is expected to grow from 28,000 today to 47,000 by 2030, with Pratt & Whitney capturing 42% of the market.

The competitive moat surrounding each of UTC's businesses is vast, as this company focuses on the development and installation of large, complex infrastructure products, and then derives much of the company's future revenue from servicing agreements. Aftermarket services currently generate more than 47% of the company's $64.5 billion in revenue. In addition, these services are always in high demand because UTC's products are extremely expensive and are used in critical, heavy-wear applications (one cannot have elevators, security systems, building air-conditioning units, or jet engines failing).

UTC is at an inflection point. The company received final approval during the 4th quarter of 2018 to complete its $30 billion acquisition of aircraft parts maker Rockwell Collins. This purchase represents the largest

aerospace deal in history and presents UTC with an opportunity to evaluate its conglomerate structure. As we stated previously, the conglomerate structure can eventually fail as an organization becomes too large, disbursed, bureaucratic, and complex to manage—UTC is now facing this dilemma. UTC's conglomerate structure is outliving its usefulness at enabling UTC to grow and/or survive, as the organization has moved well beyond a single industry. The large conglomerate structure of UTC has become an anchor around each individual business—Aerospace, Otis elevators, and Carrier air conditioners. Thus, UTC's board has decided to break up its conglomerate structure and divide the company into three distinct businesses over 2019-2020, with Aerospace remaining as United Technologies and Carrier and Otis spinning off from the parent. We support this strategy that will enable each business to focus 100% on their respective markets. Ultimately, we believe this breakup will unleash value potential based on the individual companies' newfound flexibility to flourish and compete within their respective industries. As this breakup occurs, our intention is to hold on to all three separate companies.

In the meantime, during 2018, UTC earned an adjusted $7.25 per share in profit—a 9% increase from 2017. We expect per-share earnings to grow an additional 7% in 2019, to $7.75. When comparing the forward owner's cash stream of $7.50 per share to the company's year-end stock price of $106.48 per share, investors are receiving an entry owner-earnings yield of 7% on their UTC investment—and we expect the per-share cash stream to grow over the next decade, especially with the company's ongoing share repurchase plan. We remain very enthusiastic owners of UTC and believe we are receiving a very good return on our ongoing investment in this company that includes three wonderful businesses.

CSX Railroad

CSX is one of the nation's oldest railroads, with roots in the nation's first common carrier—the Baltimore & Ohio (B&O) Railroad, which was chartered in 1827. As one of two major north/south railroads, CSX provides an important link to the transportation supply chain through its approximately 21,000 route miles of track that serves major population centers in 23 states east of the Mississippi River, the District of Columbia, and the Canadian provinces of Ontario and Quebec. The company is large, with more than 4,000 locomotives and more than 78,000 freight and container cars that provide access to more than 70 ocean, river, and lake port terminals along the Atlantic and Gulf coasts, the Mississippi River, the Great Lakes, and the St. Lawrence Seaway. CSX also has an intermodal business that links customers to railroads via trucks and terminals.

In 2018, CSX generated approximately $12.25 billion in revenue—7.4% more than 2017. As a result of the revenue increase and operating efficiencies, CSX's adjusted operating income and net profit rose by 22.5% and 27%, respectively. The soaring profits at CSX this past year requires some explanation. In 2017, the company began transitioning its operating model to what is referred to as "precision-scheduled railroading," which is focused on developing and strictly maintaining a scheduled service plan with an emphasis on optimizing railway assets. As this operating model has been successfully executed, CSX's customer service has improved, costs have decreased, and free cash flow has grown exponentially. With its profit growth this past year, we remain very positive about our ownership position in this one-of-a-kind railroad. A few highlights from CSX in 2018:

- CSX's unit volume increased approximately 1% in 2018. Revenue increased more than 7%, however, due to gains in railroad efficiencies and increased pricing. A 4% increase in coal volume was a highlight in 2018—this second year of growth in coal volume is a positive after the severe decline experienced in previous years. Although coal will never be the major energy source it was in the past, it is encouraging to see this continued turnaround in volume and revenue. Looking into the future, we expect coal to remain a strong category for CSX as the company continues to transport domestic coal to electricity-generating power plants, steel manufacturers, and industrial plants over a great part of the U.S. and around the world.

- As economic growth continues around the world, CSX's intermodal business experienced a volume and revenue increase of 2% and 8%, respectively, in 2018. This positive result follows a year-over-year 3% increase of intermodal volume in 2017—we are also happy with this positive result. Intermodal and other business now accounts for approximately 45% of volume and 20.5% of revenue for CSX. We expect that the intermodal line of business will grow again in 2019 as the global economy continues to advance.

During 2018, CSX passed approximately $4 billion of cash over to shareholders in the form of dividends (around $750 million) and share repurchases (another $3.25 billion). In 2019, we anticipate that CSX will grow per-share earnings (+10%) as the U.S. economy grows and the railroad continues to execute precision-scheduled railroading. We expect CSX to distribute an additional $3.2 billion to shareholders through a combined dividend and stock repurchase program. This provides shareholders an approximate 6.1% forward pass-through yield at CSX's year-end price, and we believe that this yield will grow over time as freight traffic increases over CSX's fixed-rail network.

In summary, we think our investment in CSX is an opportunity to participate in the growth of the U.S. and global economies, which may accelerate in the next few years due to infrastructure investment. We believe that the growth in CSX's freight volume will endure over the upcoming decade and may increase more than many analysts expect. Furthermore, we expect CSX to continue to execute precision-scheduled railroading to lower the company's expenses, increase revenues, and improve its operating ratio. (The operating ratio is an important measurement in the railroad industry, representing the percentage of revenue used to operate the railroad—the lower, the better.) The projected growth in freight volume and strong pricing, coupled with lower expenses, will leverage CSX's income and cash available for shareholders. We remain excited long-term owners of CSX, which occupies an important position in our portfolio.

HEALTHCARE GROUP

The healthcare industry remains a long-term lightning rod for government intervention due to ongoing uncertainties about the stability of healthcare reform and ongoing wrangling between government and industry parties over drug pricing and the long-term impact of increasing healthcare costs.

Where do we stand on this today? We have not altered our opinion over the past year—despite continued ambiguity plaguing healthcare reform, our view remains pragmatic: We believe in balance, and that healthcare reform is well under way. It seems that any extreme actions (e.g., drug pricing controls and/or lowering reimbursement rates for elderly healthcare) would be overly aggressive as well as difficult to execute. The side effects of lowering profits and the competitive capability of many companies participating in the healthcare industry would negatively impact the future requirements of managing an aging population.

We believe we are at the precipice of delivering the greatest medical miracles in human history. New drugs will manage or eradicate debilitating diseases such as cancer, diabetes, and Alzheimer's and reduce human suffering. The cost of ongoing research and development required to advance these drugs is enormous, as is the cost of patient care for those inflicted with intractable diseases. In many cases, the high cost of curing these diseases is surpassed by the even higher cost burden associated with chronic patient care. Unfortunately, the continued global decline in R&D productivity is one of the most important challenges the healthcare industry is facing. Blockbuster therapies have become increasingly rare, and many drugs continue to face reimbursement challenges in key markets, resulting in declining revenues for companies. Government barriers to developments in this area of healthcare presents a crucial problem that must also be addressed.

On the other side of the coin, we also know that people have a natural desire to monitor their health and are willing to adjust their lifestyle to remain healthy—hence, the increasing use of "wearables" such as Apple Watch® and Fitbit®. We expect to see continuous "passive" health monitoring become the norm in the near future, a development that will eventually benefit the healthcare industry's skyrocketing costs as "high tech" health consciousness capabilities begin to improve long-term health. Just imagine the day when any alteration to your body's normal biological function is immediately detected. Then add personal genomic data to the mix. As artificial intelligence grows from advanced data analytics and monitoring, and we gain a better understanding of real-time body function, drugs and medical devices will be developed that are tailored to individual patients and their specific health conditions, addressing the intractable health challenges of today. Healthcare companies will evolve from reactive to proactive entities that provide opportunities for early detection of diseases, along with interventions that improve patient outcomes and how healthcare is delivered.

In addition, healthcare companies that serve as intermediaries and focus on value-based reimbursement are positioned to become dominant entities over the next 10 years. Value-based reimbursement, where Accountable Care Organizations (ACOs) share financial risk in delivering savings in patient care, will accelerate the introduction of new care models and bring new capabilities to the healthcare system. The more the system moves to value-based reimbursement and risk-based models, the faster solutions will be deployed to more effectively manage patient populations in new and different ways. In other words, the patient and the

healthcare provider will all be rewarded for improving care through effective monitoring and efficient intervention.

With all the churn occurring in the healthcare space due to healthcare reform, new drug development, and advances in population healthcare and technology, it has become increasingly difficult to predict the future of companies involved in healthcare-related fields. Thus, we continue to emphasize great care when selecting companies in which to invest in this sector of fast-developing information, moving parts, and rapid transformation. We believe that the uncertainty that characterizes the industry provides opportunity to own the "right" healthcare companies that do not carry the typical high risks associated with this sector but are positioned to provide many of the solutions we mentioned, and contribute to healthcare cost reduction. Medtronic has been a company that fits our long-term healthcare investment criteria. However, with ongoing changes in healthcare, and the necessity to rapidly adapt to healthcare disruption, all companies (including Medtronic) are having to quickly reposition for the future in this dynamic industry – making their future returns less certain.

Medtronic

We have maintained our position in Medtronic over the years, a therapeutic and diagnostic medical technology company with a global reach that extends to 160 countries. Medtronic is a different and more diverse company since the completion of its merger with Covidien in 2015.

The "new Medtronic" is now benefiting from unparalleled breadth across its product portfolio. Medtronic's acquisition of Covidien has produced a powerhouse in the medical technology space. Coupling Medtronic's diversified product portfolio pointed at a wide range of chronic diseases with Covidien's extensive product line targeting acute care in hospitals has bolstered Medtronic's position as a crucial partner for its hospital customers.

The post-reform healthcare world has higher hurdles for securing reimbursement for next-generation technology, and Medtronic has now shifted its strategy to focus on partnering more closely with its hospital clients by offering a greater breadth of products and services to assist hospitals to operate more efficiently. Through partnering more closely and integrating itself into hospital operations, Medtronic seems well positioned to take advantage of emerging business opportunities in a value-based reimbursement environment.

In the meantime, Medtronic remains focused on designing and manufacturing devices to address cardiac care, neurological and spinal conditions, and diabetes. The firm's fundamental strategy of innovation in its historical space is intact—Medtronic is often first to market with new products and has invested heavily in internal research and development efforts as well as acquiring emerging technologies.

During fiscal 2018, Medtronic reported total net sales of $30.0 billion, which is broken into the four following operating segments: Cardiac and Vascular Group ($11.4 billion), Minimally Invasive Technologies Group ($8.7 billion), Restorative Therapies Group ($7.7 billion), and Diabetes Group ($2.1 billion). The company's approximate $6.2 billion of earnings are largely available for distribution to shareholders, representing a 5% owner-earnings yield at the company's year-end price. Our expectation is that Medtronic will return money to shareholders in 2019 via a $2.00 per-share dividend ($2.7 billion) and will continue its stock repurchase plan, acquiring around $2.4 billion of stock over the next 12 months—representing a pass-through yield of 4.17% at the company's year-end stock price.

TECHNOLOGY GROUP

Every year we begin this section by highlighting the opportunities presented by the information technology area, along with the difficulty of choosing the right companies to invest in over the long term. Business disruption is the norm in this sector and, therefore, companies and their investors can never rest on past success. During 2018, the technology sector experienced change at breakneck speed once again as device miniaturization continued, cloud computing flourished, and software enhancements enabled the advancement of artificial intelligence in the technology marketplace.

The inherent disorder and warp-speed change of the IT sector continues to make it extremely difficult to determine which companies will succeed or fail. More than 11 years ago, Steve Jobs introduced the iPhone® to the world, and this single device allowed Apple to become a primary technology disrupter. That technology

cycle has now passed, with competitors hungry for market share developing “copycat” Apple products. Disruption is now taking hold as more innovative devices enter both the consumer and commercial markets. In addition, exponential growth in cloud-based services continues in both consumer and commercial markets. Amazon is the leading technology disrupter with its cloud service business, Amazon Web Services (AWS), which is used by companies such as Netflix to manage and stream content to their customers.

Computer miniaturization and the emergence of the “Cloud Computing Era” are driving a new generation of products and services that empower individuals to interconnect, be entertained, and stay informed 24 hours a day, 7 days a week. Technological advances have yielded powerful computers that fit into the palm of one’s hand or on one’s wrist, with the ability to track activity and fitness at every step and the power to capture health data in the cloud. The new types of devices, high-speed connectivity, and fast-changing information services remain a challenge for old-fashioned computer companies that rely primarily on sales of previously popular hardware devices such as PCs. The “new space” companies competing to provide personal interconnectivity, cloud-based networking technologies, and advanced interface and mobile technologies include Arista, Veeva Systems, EPAM Systems, Synaptics, and Synchronoss Technologies. The “older technology companies”—Apple, Fitbit, Samsung, Facebook, Twitter, Amazon.com, Salesforce.com, IBM, Google, Cisco, Oracle, and Microsoft—are also in the fray, remolding their organizations to keep pace with the new technology ecosystem.

Which companies gain competitive control in the evolving IT ecosystem continues to be anyone’s guess. But we remain committed to watching for and responding to investment opportunities as they arise in this fast-moving sector. Our goal is to identify the difference between price and value with certain technology companies that we believe occupy a strong competitive position in the developing technology landscape. Even so, we are unable to point to any one company in this industry that could be placed in the “guaranteed invaluable business basket”—there is too much disruption, which makes it hard to call.

With this perspective, we are invested in what we believe to be technology companies that provide core technology that all individual and commercial customers need. Our large technology holdings include Microsoft, Alphabet (Google), and Intel.

Microsoft

We have mentioned in past letters how, six years ago, Microsoft was struggling with its primary product—Windows—in a changing technology landscape. This resulted in the company's decision to become “more like Apple” and led to the purchase of Nokia’s phone business for $7.2 billion in late 2013—a highly competitive arena that included Apple, Samsung, LG, and many others. Microsoft’s pursuit of a consumer-centric business model was ill-conceived, and the company’s business and leadership stumbled.

Just as Microsoft’s ill-adapted business model seemed to threaten the very livelihood of the company, Microsoft’s board, influenced by Bill Gates, made a crucial decision to make a management change. In early 2014, Microsoft’s board of directors chose Satya Nadella to lead the company. Applying his background in cloud and enterprise computing, within 60 months, Mr. Nadella led Microsoft back to the forefront of technology change. The organization had turned on a dime and successfully shifted its primary focus away from Windows and devices to providing enterprise applications and cloud-based services to small, medium-size, and large businesses.

We have been emphasizing the emergence of cloud computing, which is the delivery of computing as a service instead of as a product. Using cloud computing, customers share resources, software, and information that are provided as a metered service over the Internet to personal computers and other devices. Cloud computing is analogous to an electric utility, whereby the power station delivers power to the electrical grid, and consumers draw down on that power as they need it—and are charged based on their usage. The infrastructure that supports cloud computing comprises large data centers (i.e., server farms) that are owned and operated by companies such as Amazon, Microsoft, Google, and Rackspace. Obviously, cloud computing offers businesses an opportunity to reorganize their IT infrastructure and decrease their reliance on corporate servers—resulting in overall savings in their IT spending budgets.

This is an area of the technology industry that is “sticky” because corporate customers are not as fickle as retail consumers, who change products at a heartbeat. The “utilitization” of the enterprise cloud segment of the business is very attractive, as well as potentially very profitable, due to its tentacle-reaching and long-term annuity-like attributes. Organizations such as Boeing, CarMax, Coca-Cola, Exxon, and others are using

Microsoft's data management, machine-learning analytics, and cognitive services to infuse intelligence into their business applications. The far-reaching applications of Microsoft's "intelligent" cloud business include cognitive applications such as vision, speech, text, as well as facial and emotion detection. Microsoft's market share of the cloud infrastructure business has jumped from 10% in 2017 to approximately 14% in 2018. Meanwhile, Amazon lost one point of market share in 2018 but is still the dominant cloud provider, with a 33% share. The cloud computing business is in the early innings. We believe that the future presents unlimited potential for Microsoft, and that Mr. Nadella is committed to staying at the forefront of this technological revolution.

Microsoft had another year of exciting business results in 2018, and we are enthusiastic about the company's prospects in 2019. Microsoft's adjusted calendar earnings are expected to be $4.31 per share in 2018, putting the company on pace to reach per-share earnings of over $5.25 by year-end 2020. During 2019, Microsoft will generate approximately $38 billion of owner-earnings and will return a large amount of this cash to shareholders through net share repurchases of approximately $13 billion and around $13 billion of dividends (an approximate 3.3% pass-through yield at the year-end stock price). With a consistent return of cash to owners of this company and an excellent position in the technology industry, Microsoft will remain a long-term position in our portfolio.

Alphabet (Google)

During 2017 and 2018, we made a large investment in Alphabet (Google), transitioning our emphasis from IBM. We now hold a significant position in Alphabet (Google) and consider this investment to be a long-term strategic holding in our portfolio.

We have stated that the technology industry landscape has changed dramatically over the past five years, enabling the emergence and application of artificial intelligence. With the rise in cloud computing, massive amounts of information is housed on interconnected computers around the world, and companies seek to turn this information into useful knowledge using various applications and data analytics capabilities. The emergence of "edge and fog computing" has allowed intelligence to be distributed to individual devices such as phones and computer tablets. In addition, computer utilitization is truly coming of age through a new way of writing software that has developed in recent years. "Serverless computing" is a cloud-based computing utilization model in which the cloud provider dynamically manages the allocation of machine resources. It is a form of utility computing, with pricing based on the actual amount of resources consumed by an application, rather than on pre-purchased units of capacity. The term "serverless" is a misnomer, since this computing still requires servers; the term "serverless computing" reflects server management and capacity-planning decisions that are completely hidden from the developer or operator. This environment requires far less work from programmers and achieves dramatically greater results. Ultimately, serverless software-writing makes it easier for programmers to use cloud computing in general but can also weaken a programmer's brand loyalty to any one cloud computing organization.

Cloud, fog, and serverless computing capabilities are especially robust in the enterprise and hybrid computing environments, where massive amounts of crucial government and corporate information is gathered, stored, and combined with public information. The need to transform massive storehouses of data into working knowledge has led to the emergence of cognitive computing—the simulation of human thought processes in computerized models—whereby computers actually learn, and even teach. Today's digital intelligence is based on massive data-gathering and analysis, but artificial intelligence is definitely on the horizon.

Computer giants such as Amazon, Microsoft, Alphabet (Google), and IBM are working diligently to make advanced computer learning a reality in this new environment. We believe that Alphabet has a tremendous opportunity to penetrate the growing artificial intelligence technology segment.

Alphabet is the parent company of Google's growing portfolio of businesses that span several industries including technology, life sciences, investment capital, and research. Alphabet's largest business is its Google subsidiary. Google focuses on Internet-related products and services that include internet search, online advertising technologies, cloud computing, and software and hardware development. For those that are interested—Google's market share of global online searches exceeds 80% (most people just "Google" it!). The company's meteoric growth since its founding in 1998 has triggered a number of products, acquisitions, and partnerships beyond Google's core search engine. Google offers services designed for work and productivity (Google Docs), email (Gmail), scheduling and time management (Google Calendar), cloud storage (Google

Drive), language translation (Google Translate), mapping and navigation (Google Maps/Waze), video sharing (YouTube), and a multitude of other products. The company also developed the Android mobile operating system, the Google Chrome web browser, and Chrome OS, a lightweight operating system based on the Chrome browser.

So why does Alphabet have a tremendous opportunity in the artificial intelligence space? The pervasive use of Google's search engine is allowing Alphabet to gather, manipulate, and understand our individual and collective behaviors in complex ways, giving the company an edge in developing artificial intelligence. Google itself is a learning machine that adapts each day based on the intelligence it gathers from internet searches. This growing knowledge is allowing Alphabet to develop offshoot businesses as the company learns, and to populate these companies with intelligence to compete in emerging markets, such as self-driving vehicles (Waymo), data science and healthcare (Verily), and the application of artificial intelligence (DeepMind).

Alphabet is an extremely profitable company and produced adjusted earnings of $38 billion in 2018, or $53.65 per share. In 2019, Alphabet is expected to grow its per-share earnings to $56.50 and produce owner-earnings of approximately $34 billion. This will add to Google's $100+ billion cash hoard on its balance sheet, with minimal debt. With a total market capitalization of $723 billion and removing cash of approximately $105 billion, a buyer of Google is obtaining a 5.5% owner-earnings yield that is growing at approximately 12% to 15% per year. We think that at the current price, Alphabet provides us an opportunity to own a great collection of promising enterprises that will become even greater in the future.

Intel

Intel is a leading designer and manufacturer of advanced integrated digital technology platforms. An Intel platform consists of a microprocessor and chipset that may be enhanced by additional hardware, software, and services. Intel sells technology platforms primarily to original equipment manufacturers (OEMs), original design manufacturers (ODMs), and industrial and communications equipment manufacturers in the computing and communications industries across the computing continuum—in servers; in desktop, laptop, tablet, and mobile phone devices; and in the Internet of Things. (The Internet of Things is the concept of a network of Internet-connected entities such as electronic devices, vehicles, buildings, kitchen appliances, etc. that are able to collect and exchange data using embedded sensors, empowering real-time computing in digital surveillance, new in-vehicle experiences, advancements in industrial and office automation, solutions for retail and medical industries, etc.).

Intel holds a dominant market share in many of its product categories. Despite this dominance, however, technology disruption is impacting even Intel as consumers rapidly transition from primarily using desktop and laptop computers to smaller tablet and mobile devices. On top of the shift from midsize to smaller devices, the growth of cloud-based computing based in large data centers is replacing the need for people to acquire and maintain "home-based" personal computing capabilities. Because of this double-whammy technology shift, Intel's mainstay platform sales to the midsize, local computing segment (i.e., PCs) is declining. Thus, Intel continues to face a challenging period, and the company is evolving its business model to meet the growing demand for integrated digital devices and cloud computing products.

So, why are we maintaining a large position in Intel, especially as the company encounters a disruptive period that creates additional business uncertainty?

We believe that Intel has embarked on a promising strategy (encompassing both hardware and software) to solidify its position in a new era in which computing is interconnected and distributed across a variety of platforms. The company offers enhanced energy-efficient performance and connectivity and provides platform solutions that now span the computing continuum—from high-performance computing systems running trillions of operations per second to embedded applications consuming milliwatts of power.

As the boundaries of computing expand, with billions of devices connected to the Internet and to one another, Intel remains focused on the following areas:

- accelerating the company's growth in data centers
- extending the company's growth in the Internet of Things
- developing memory and programmable solutions

Intel's emphasis on these areas is driving the company to develop complete and connected platform solutions that will maximize the computer user experience. These focus areas are also driving synergistic business

organization and growth among Intel's business groups: Data Center Group, Internet of Things Group, and Non-Volatile Memory Solutions Group.

Intel's microprocessors form the backbone of the Internet and cloud-based computing. Data Center Map (a web service that serves as a liaison between providers and buyers of data center services) states that approximately 4,360 co-located datacenters in 122 countries (around 40% located in the U.S.) make up what we can call the "global computing platform." These datacenters collectively contain more than 65 million computer servers, most of which are running on Intel products.

We are witnessing Intel transform and broaden its scope as the Internet of Things develops. As more devices become smart and connected, demand will grow for data centers to not only connect these devices but to capture and analyze the data they create. In addition, improvements in memory technology are enabling faster and more efficient microprocessors. Intel calls the cycle of growth that results from the synergistic interaction of these three market segments the "Virtuous Cycle of Growth." As the company executes its networked, integrated product strategy, these market segments will continue to have greater impact on the company's results and further widen its competitive advantage.

In summary, Intel is managing the current technology disruption well, and the company is positioning itself for the next generation of computing. We believe Intel will play an important role in the utililization of computing and will obtain a terrific revenue and profit annuity stream in future years through its multi-product offering in both high-end and low-end computerization.

Intel's revenue for 2018 was approximately $71 billion—this compares to the firm's forecast of $65 billion at the beginning of the year. Revenue outpaced expectations due to broad-based strength in the PC and data center markets, plus traction from Mobileye's EyeQ chips, Altera's server FPGAs, memory, and modems for Apple's iPhone. As a result, Intel will earn approximately $4.55 of earnings per share in 2019. We expect the company to continue its growth in future years as it further penetrates the data center sector and works toward developing a profitable foothold in new business segments such as the Internet of Things. In 2019, we expect Intel to generate approximately $16 billion of owner earnings and return approximately $13.5 billion of cash to shareholders through dividends of $5.5 billion and share repurchases of approximately $8 billion, respectively—Intel's dividend yield is approximately 2.56% at the year-end stock price, and the forward pass-through yield is approximately 6.3% when including share repurchases. We still consider Intel a well-positioned technology company and a good investment given its optimistic future.

FINANCIAL SERVICES GROUP

Berkshire Hathaway

Berkshire Hathaway remains our largest financial services holding as well as our largest overall position. Berkshire Hathaway experienced an approximate 1% growth in per-share book value during 2018. This was a a small increase from the 23% growth in per-share book value during 2017 (due to the lower corporate tax rate that benefited Berkshire), and 11% growth in per-share book value achieved in 2016. This year's slower per-share book value growth can be attributed to the negative performance of Berkshire's equity portfolio, including the 7.3% loss in Apple's share price (Berkshire is now Apple's 3rd largest shareholder, representing an approximate 5.4% ownership position in the company). Other large holdings that declined this year include Bank of America (down ~17%), Wells Fargo (down ~ 25%), American Express (down ~ 4.5%), and Kraft/Heinz (down ~ 45%— Berkshire owns 26.7% of this company). We estimate that Berkshire's overall equity portfolio was down approximately 13% in 2018—worse than the market average. However, we believe these positions to be undervalued, and to do well over time – contributing to the future growth in Berkshire Hathaway's intrinsic value. More important, Berkshire's wholly owned companies continue to perform well and offset the stock portfolio's short-term negative impact on book value. We expect Berkshire's businesses to continue to perform well in the future, given the possible increase in infrastructure spending in the U.S. that would have a positive impact on Berkshire's industrial holdings, including Burlington Northern railroad, Precision Castparts, and Lubrizol.

A repeat from last year, but very important: Given our historical use of Berkshire's growth in per-share book value as a measurement of its growth in intrinsic value, we should revisit our discussion of the past few years about not placing too much weight on this metric as an accurate reflection of Berkshire's true increase in value.

Warren Buffett explains the ever-increasing difference between Berkshire's book value and intrinsic value in the company's 2015 annual report:

> *Over the last 51 years (that is, since present management took over), per-share book value has grown from $19 to $155,501, a rate of 19.2% compounded annually.*
>
> *During the first half of those years, Berkshire's net worth* ***(book value)*** *was roughly equal to the number that really counts: the intrinsic value of the business. The similarity of the two figures existed then because most of our resources were deployed in marketable securities that were regularly revalued to their quoted prices (less the tax that would be incurred if they were to be sold). In Wall Street parlance, our balance sheet was then in very large part "marked to market."*
>
> *By the early 1990s, however, our focus had changed to the outright ownership of businesses, a shift that diminished the relevance of balance-sheet figures. That disconnect occurred because the accounting rules that apply to controlled companies are materially different from those used in valuing marketable securities. The carrying value of the "losers" we own is written down, but "winners" are never revalued upwards.*
>
> *We've had experience with both outcomes: I've made some dumb purchases, and the amount I paid for the economic goodwill of those companies was later written off, a move that reduced Berkshire's book value. We've also had some winners—a few of them very big—but have not written those up by a penny.*
>
> *Over time, this asymmetrical accounting treatment (with which we agree) necessarily widens the gap between intrinsic value and book value. Today, the large—and growing—unrecorded gains at our "winners" make it clear that Berkshire's intrinsic value far exceeds its book value.*

This explanation highlights how the value of many of the businesses Berkshire has purchased over the years has increased enormously, but accounting for those 100%-owned entities does not allow for these businesses to be marked up to reflect their increase in value on Berkshire's balance sheet. For example, Berkshire purchased Burlington Northern Santa Fe railroad (BNSF) in early 2010 at an equity value of approximately $34 billion (a note to finance aficionados: This acquisition added around $14.8 billion of goodwill to Berkshire's balance sheet). Around nine years later, however, the equity value of BNSF on Berkshire's balance sheet is likely in the range of $100 billion. The approximately $66 billion hypothetical increase in BNSF's equity value is not currently reflected on Berkshire's balance sheet because the company is no longer a marketable security that trades on the exchange; rather, BNSF is now a wholly owned subsidiary of Berkshire. Standard accounting practice does not permit Berkshire to mark up BNSF to reflect its increasing value in Berkshire's balance sheet, however, which has contributed to a widening of Berkshire's book value vs. intrinsic value over time. This is also the case for other wholly owned companies Berkshire has acquired over the years—as these companies have grown in value over time, the disparity between book value and intrinsic value increases. This anomaly will continue into the future (and likely continue to widen) as Berkshire's wholly owned businesses grow in value and Warren Buffett makes outright purchases of new businesses, adding them to the company fold.

Adding another insult to injury on the book-to-market value measurement of Berkshire's worth, a new accounting rule instituted in 2018 states that the net change in *unrealized* investment gains and losses in stocks Berkshire holds must be included in all of the company's reported net income figures. This requirement produces potentially large swings in the company's reported GAAP bottom line. For example, Berkshire now owns approximately $200 billion of marketable stocks (not including its shares of Kraft Heinz), and the value of these holdings can easily swing by $15 billion or more within a quarterly reporting period. (Remember, there is a 75% chance of a 10% market correction that can take place every year). When Berkshire includes gyrations of this size in its reported net income, the important business numbers reflecting Berkshire's operating performance will be "tucked under the rug." For business analysts who traditionally rely on changes in book value as a measurement of intrinsic value creation, Berkshire's basic quarterly reporting will now become even less useful. (A side note: This new accounting rule adds further challenges to Berkshire on top of the old accounting rule, whereby *realized* security gains or losses are also included in reported net income.) Bottom line: With the combination of the new and old accounting rules, book value will become a "bouncing ball."

Ultimately, book value still serves as a fair proxy for Berkshire's value creation but is quickly losing its luster as time progresses and the company pursues full ownership of businesses. In addition, this measurement of progress in intrinsic value becomes less ideal as accounting rules change—especially in reporting changes with equity holdings that are very large. At the year-end 2018 stock price, Berkshire's per-share market value is

approximately 1.35 times its per-share book value. We estimate that trading at approximately 1.35 times the company's per-share liquidation value (without allowing for any adjustments for wholly owned companies that have increased in value), Berkshire's intrinsic worth continues to be greater than its current market price.

Berkshire keeps growing and effectively allocating capital that is creating greater intrinsic value for shareholders. Berkshire continues to flex its financial muscle, producing long-term value from a well-established financial business that consistently generates a low cost of borrowed customer funds (less than zero over time). The float produced by Berkshire's insurance subsidiaries "sticks" within the company for many years—i.e., Berkshire gets to maintain premiums paid by insurance customers for years prior to paying out claims. Berkshire primarily generates its float by providing insurance directly to individuals (through GEICO) as well as by providing coverage to other insurance companies against very large catastrophic-loss events, such as hurricanes and earthquakes (this is called "reinsurance").

With the long length of time Berkshire holds customer funds, the company benefits from investing "float" that has a long-term horizon—to obtain a highly probable rate of return on this money. Berkshire invests the funds in understandable assets and, in many cases, in wholly owned businesses that will remain a part of Berkshire indefinitely.

In summary, Berkshire's business model pivots on making investments in and/or buying good companies at attractive valuations with low-cost insurance funding. Mr. Buffett is continually buying businesses that generate very high levels of cash flow that accumulates over time—and then effectively reallocates this cash to ever-increasing opportunities. We remain enthusiastic owners of this valuable company, and we look forward to Warren Buffett's future allocation decisions as he continues to build this great business.

Wells Fargo

Toward the end of 2018, we took a rather large position in Wells Fargo Bank. Wells Fargo is one of the largest banks in the United States, gathering more customer deposits than most of its competitors. The bank's strategy relies on establishing deep customer relationships, sound risk management, and pursuing operational excellence. The successful execution of this strategy over decades has resulted in a wide economic moat for Wells Fargo, which is evidenced in the company's superior banking financials. Wells Fargo has consistently paid less for their balance sheet funding than most competitors over the past decades, and has also generated more revenue per dollar of assets than peers over time. The bank's low-cost funding can be attributed to a loyal base of longtime customers.

With the above stated, Wells Fargo has received negative news the past few years. Unfortunately, their greatest strength – pursuing customer intimacy – led to a Wells Fargo's sales culture that overheated. Rather than attempting to improve its customers' financial lives, management chose to create an environment for employees to increase revenue at all costs, introducing ill-conceived incentive programs for front-line employees to cross-sell various banking products to customers (an individual with a savings account could be convinced to open a checking account, get a credit card, transfer their 401(k), and refinance their mortgage). This sales push led to fraudulent practices of opening bogus customer accounts, and included predatory financing practices that risked customer relationships and the bank's reputation that had been built over the past century.

On Feb. 2, 2018, Wells Fargo entered into a consent order with the Board of Governors of the Federal Reserve related to the board's governance oversight and the company's compliance and operational risk. Under the terms of the consent order, the company submitted plans to the Federal Reserve that detailed completed and planned actions to further enhance the board's governance oversight and the company's compliance and operational risk management program. Until Wells Fargo executes its plan to the satisfaction of the Federal Reserve, the bank is required to hold their total consolidated assets at Dec. 31, 2017, levels – $2.0 trillion of assets. It is expected that the bank will receive permission during 2019 from the Federal Reserve to expand their assets. In the meantime, Wells Fargo's balance sheet provides the bank flexibility to manage within the asset cap, and to serve customers financial needs.

As a result of tremendous scrutiny the past several years, the company took several steps to address their challenges and to work toward building a better Wells Fargo. New management was put in place to fix what was wrong, make things right, and ensure that such problems did not happen again. Some of the broader changes the bank has made across the company following the sales practices settlement in September 2016 include eliminating product sales goals for retail bankers who serve customers in branches and call centers;

implementing a new incentive compensation program focused on customer experience, stronger oversight and controls, and team versus individual rewards within the retail bank; centralizing key enterprise staff functions like Human Resources and Finance; and strengthening risk and compliance controls companywide. The bank has also established a Conduct Management Office to centralize the oversight of ethics at Wells Fargo as well as how to handle internal investigations, complaints, and sales practices oversight. Wells Fargo simplified and streamlined the Community Bank's leadership structure to place a greater focus on what matters: the unique needs of customers, the branch team member experience, and business priorities. This new structure is more efficient, improves risk management, and brings Community Bank leaders closer to customers and front-line team members.

When looking at Wells Fargo, we noticed that customers did not abandon he bank, and believe that new programs focused on deepening active relationships will actually generate more revenue in the future. The "new" Wells Fargo is getting back to the "old" Wells Fargo that made the bank stand out well-ahead of competitors.

In 2019, Wells Fargo is expected to earn over $23 billion, and allocate most of this to shareholders via ~ $9.5 billion in dividends, and share repurchases of ~$13.5 billion. This allocation of capital to shareholders represents an owner earnings and pass-through yield of 10.5% at the company's year-end share price. At this yield, we are enthusiastic owners of this one-of-a-kind banking franchise.

American Express (Don't Leave Home Without It)

Our third-largest financial services investment is American Express (Amex). We began purchasing Amex in 2015 and completed our investment in this company with additional purchases during 2016. Since American Express has become a larger part of our portfolio, it is worth reemphasizing this company's underlying business strategy.

Most people have heard of American Express but may not be fully aware of its business. For example, many know that the American Express Company's principal products and services include charge and credit payment card products as well as travel-related services offered to consumers and businesses around the world. The company's full range of products and services go well beyond charge and credit payment card products and include network services; merchant acquisition and processing, servicing, and settlement; marketing and information products and services for merchants; fee services, including fraud prevention services and the design and operation of customer loyalty and rewards programs; expense management products and services; merchant financing products; travel-related services (including traveler's checks); and stored-value/prepaid products. American Express products and services are sold to diverse customer groups that include consumers, small businesses, mid-size companies, and large corporations.

American Express is truly a one-of-a-kind company that enjoys a unique credit and charge business based on a "closed-loop system." The simplest way to explain Amex's closed-loop system is to describe its opposite—i.e., an "open-loop system," which is how Visa and MasterCard operate. Visa and MasterCard clients are primarily banks and financial institutions, known as issuers, which issue cards to their customers bearing the Visa or MasterCard logo and bear all risks associated with extending credit. When a cardholder uses a Visa card to purchase goods or services from a merchant—let's say a store—information is sent via Visa's network to the merchant's bank, known as an acquiring bank. The customer's card-issuing bank pays the merchant's bank through the network, which then pays the merchant. The card-issuing bank then sends a monthly statement to its customer for all charges incurred during the period and may earn interest from the cardholder on any outstanding balance the customer does not pay immediately. The issuing bank may also charge the customer a fee for the use of its credit card. In addition, the issuing bank earns an interchange reimbursement fee from the merchant's bank, which charges a merchant discount fee for handling the merchant transaction. Visa participates in this network exchange by charging data processing fees and service fees to its financial clients but is not involved in lending money. Thus, unlike an issuing bank, Visa is not exposed to any credit risk and earns revenue on the volume of transactions carried out through its associated cards. Leaving aside all this transaction complexity, all we need to remember about the open-loop system business model is that it involves five separate parties that all receive a portion of the financial benefit for each transaction.

In contrast, using a closed-loop system, American Express acts as both the issuer and the acquirer by issuing its own cards through its banking subsidiaries. The company's primary source of revenue is the discount fee it charges merchants that accept the American Express card (Amex's merchant fees are usually higher than other

financial institutions, and we will explain why later). These fees are charged as a percentage of the charge amount processed for the merchant and account for approximately 60% of the company's total revenues. American Express may also generate revenue from interest earned on loans that are issued to cardholders, from cardholder membership fees, and from travel services. Unlike the Visa and MasterCard model, the American Express revenue model does not depend on the volume of transactions processed but focuses on the total amount spent by each customer. Thus, American Express employs a "spend-centric" business model, attracting affluent customers who are likely to spend more than average (the average per-transaction payment for an American Express card is approximately $100 more than Visa's.)

The American Express Competitive Advantage

In addition to its use of a single closed-loop system, American Express processes a dominant market share of the travel and entertainment expenditures of major corporations. This requires explanation and demonstrates how the closed-loop system plays a crucial role.

Large corporations like United Technologies bid out the management of their travel and entertainment budgets to travel management companies, and American Express is by far the largest in the world. Amex supplies travel and entertainment management systems to its large corporate customers that include travel planning software as well as travel and entertainment payments, including expense reporting. As part of its travel policy, United Technologies employees are required to charge all their business-related travel and entertainment expenses on their corporate-issued American Express cards. Because American Express has a dominant market share of travel management systems used by major corporations, travel and entertainment entities that wish to serve corporate clients—including restaurants, hotels, car rental companies, and airlines—must accept the American Express card. Imagine a UTC salesperson taking prospective customers out for dinner and presenting a corporate-issued American Express card for a large bill—and being told that the restaurant doesn't accept the American Express card. For obvious reasons, this scenario is a rarity. American Express leverages this advantage by charging merchants more for accepting the American Express card. This issue is a longstanding "bone of contention" between merchants and American Express—and a difficult one for merchants to negotiate, since American Express dominates the corporate travel industry.

American Express developed the closed-loop system to optimally serve its base of corporate clients that require effective management of large corporate travel and entertainment budgets. The American Express travel and entertainment expense management system collects all travel and entertainment information and allows American Express and its corporate customers to jointly negotiate discounts for airfares, hotel and car rental rates, etc.

In summary, American Express' competitive advantage lies in the company's unique ability to assist the corporate customer segment with a travel and entertainment expense management system that is unmatchable. The company's wide-ranging closed-loop network in this area is unique and will continue to provide a competitive advantage as social media evolves and targeted advertising to corporate customers in a mobile world becomes more prevalent. This one-of-a-kind business model will continue to serve a broad-based platform for consumers, merchants, and future partnerships like no other product.

The benefits of Amex's closed-loop system are not limited to providing major corporations exceptional management of travel and entertainment expenses. This special business system also serves small and midsize companies by providing a different and unmatchable supply-chain management-expense control system. The American Express OPEN product leverages the closed-loop system to tie in a company's suppliers (for inventory and payables) as well as its customers (for receivables). The way it works: American Express has an extended merchant network that includes many different suppliers and small businesses that purchase from each other, which then sell to large corporations that already are part of the Amex network. Deploying emerging data analytics and artificial intelligence technology, American Express is able to provide a unique capability that matches suppliers to corporations and assists in inventory management as well as cash management—offering additional terms, as well as benefits, to suppliers and corporate customers. Amex can also leverage the knowledge/information generated by its extended network to negotiate discounted rates on various supplies that small companies may not be able to achieve on their own.

It is our opinion that American Express is not (and never has been) just a "card company" that serves the masses. The chase for low-producing, price- and credit-sensitive consumers will likely be left to banks that are not brand-sensitive but have a desire to create scale primarily by lending to lower-quality, fickle consumers (most consumers in this segment seem to trade credit cards like we used to trade baseball cards).

We believe that American Express has an ongoing opportunity to cross-sell and increase its share of customer financial transactions through additional cards issued in the growing high-end consumer segment. This niche opportunity will continue to develop for many decades as the percentage of "wealthy consumers" grows globally. We also believe that American Express has an opportunity to expand its closed-loop financial transaction business model to other industries such as healthcare, where a dominant intermediary payment system does not really exist. Many experts looking at the U.S. healthcare industry believe that, as in other industrialized countries, a single-payer system is needed to enable negotiation of better healthcare services and drug prices. We believe that this could be accomplished in the U.S. with institutions using a single payment system. This will allow institutions (such as corporations) to track employee healthcare services and drug purchases in real time, creating an environment for businesses to receive negotiated lower healthcare costs for their employee population.

During 2018, American Express produced around $6.35 billion of earnings, or $7.40 per share. The company distributed about half of its earnings to shareholders—through dividends of $1.3 billion and share repurchases of approximately $1.9 billion—representing a pass-through yield of 3.9% at the year-end stock price. In 2019, we expect American Express to increase its earnings per share 9.5%—to $8.10. With American Express' tremendous future in a global marketplace where cash sales are diminishing, higher-income consumers are growing, and corporate productivity pressures are mounting, we remain enthusiastic owners of this great franchise.

RETAIL GROUP

Our major retail holdings—Home Depot and Walgreens Boots Alliance—enjoyed another year of expansion in 2018, with retail purchases growing at 7.5% and 4.5%, respectively, at these specialty businesses. Year-over-year sales increased by approximately 6% for these combined entities in 2018, and our expectations are that their combined sales growth will exceed 3% in 2019. The expanding intrinsic business value of both Home Depot and Walgreens was not fully reflected in their stock prices this past year, however. We remain fervent owners of these two great businesses, and we are confident that the growth of intrinsic value will be reflected as these organizations continue to execute the four essential elements of retail success:

1. **Excellent customer service:** If individuals walk into your store and get a whiff of poor customer service, they will likely turn around and shop elsewhere. Customer service is paramount in the retail business, and not something any retailer can compromise on.
2. **Product selection and superiority:** A retailer must constantly ensure that it is offering the right selection of products at the best possible price. You can provide a great service to your customer with attentive associates and a wonderful retail atmosphere, and then deliver a disservice by stocking the right products at the wrong price, the wrong products at the right price, or—worse yet—the wrong products at the wrong price.
3. **Value creation:** It is tough—perhaps very tough—to make money in retail. A robust understanding of product turnover, day-to-day revenue and expense management, and long-term capital allocation decisions all play into successful value creation.
4. **How to blend one's so-called "bricks and mortar" offering with the new "online channel:"** Interconnected retail continues to be a growing dimension of this industry. Successfully integrating the in-store and online customer experience is essential to creating customer and company value.

We have stated several times in the past how retailing has many moving variables that require tending each and every day. Inattention to any of these details leads to self-destruction—for example, Sears (now bankrupt) and J.C. Penney continue to struggle in one or more of these areas, resulting in sales and profitability challenges.

Our interest is in large, industry-specific retailers that gain economic value as their industries consolidate over the long term—Home Depot and Walgreens Boots Alliance continue to fit our perfect retail description. These retailers are adding value as their specialty segments continue to undergo consolidation and small competitors fall by the wayside, a dynamic that seems to be accelerating in both the home improvement and drug retail spaces. The retail areas in which we are invested focus on a couple of two-horse races—between Home Depot and Lowe's in the home improvement market, and between Walgreens Boots Alliance and CVS in the retail pharmacy market—with the possibility of Amazon taking share in the drug retail space in the future with its

purchase of PillPack. These retailers continue to gain ground in the difficult retail spaces in which they participate and will likely gain additional ground in upcoming years—worldwide. We have not changed our view: Our retail enterprises are extremely valuable, and it is very difficult for new competitors (including Amazon) to gain a foothold in these specialized retail segments that require substantial networked infrastructure and real estate development.

Home Depot

Home Depot repeated another fantastic year as the company's 2,286 stores increased sales per square foot approximately 6%, with gross margins hovering around 34.4%—higher sales coupled with a high profit margin in this space leads to maximizing shareholder value. In 2018, Home Depot's sales of "big ticket" items such as appliances, lumber, and flooring increased—the average ticket sale was around $65.79, compared with $62.78 last year, representing a 4.8% increase for each customer transaction. This is an indication that customers continue to invest in their homes throughout the U.S. As a result, Home Depot is thriving and will continue to prosper as the company relentlessly focuses on providing the best of the four "great retailer" legs outlined in our industry introduction.

Home Depot's relentless focus on customers experience remains anchored on the company's principle of "customers first." During 2018, the company continued to invest in digital platforms including content, website improvements, and the customer mobile experience. This digital strategy provides a frictionless interconnected experience online while also remaining focused on improving the interconnected customer experience in the store. In 2018, sales from Home Depot's online channels continued to increase, with an astounding 3rd quarter increase of 28% over the same period in the previous year. E-commerce sales now represents 7% of total net sales. This percentage is likely to grow in the future.

Home Depot is continuing its focus on product authority, facilitated by the company's ongoing merchandising transformation and portfolio strategy, which is focused on delivering product innovation, assortment, and value. Home Depot is dedicated to being the leader in product authority, connecting products and services to the needs of customers. During 2018, the company continued to collaborate with suppliers to introduce a wide range of innovative new products for its do-it-yourself, do-it-for-me, and professional customers while remaining focused on offering everyday values in stores and online. For example, the company annually awards innovative suppliers its "Innovation Award" that recognizes the development of new and relevant products. The 2018 awards included recognition for LifeProof Slip Resistant Tile (which is 50% more slip-resistant than ordinary tile) and Behr Quick Dry Oil-Based Wood Finish, which dries in just 60 minutes on damp wood.

In 2018, Home Depot also focused on productivity and efficiency. The company is driving productivity and efficiency through ongoing operational improvement in its stores and supply chain with the goal of reaching more customers. In 2018, Home Depot announced that it will spend $1.2 billion over the next five years to speed up delivery of goods to homes and job sites as the rise of online shopping resets consumer expectations. As part of this initiative, Home Depot will add 170 distribution facilities across the U.S. so that it can reach 90% of the U.S. population in one day or less. Among the new distribution sites, direct fulfillment centers will be included to provide next-day or same-day delivery of routinely ordered products.

We expect Home Depot to earn approximately $9.63 per share in calendar 2018 (up over 30% from 2017) and to increase earnings another 6% in calendar 2019—to approximately $10.20 per share. By staying focused on the four-legged stool of retail success, Home Depot continues to produce significant amounts of cash that is being distributed to shareholders. The company will generate nearly $12 billion of owner earnings in 2019 and will return this cash to stockholders through share repurchases of approximately $7 billion and $5.1 billion of dividends (~ 6.2% forward pass-through yield at the year-end stock price). We remain delighted with the company's ongoing focus on customers and shareholders and plan to remain long-term owners of this one-of-a-kind specialty retailer that is sidestepping the retail disruption of online-focused e-tailers such as Amazon.com.

Walgreens Boots Alliance

Walgreens Boots Alliance is another one-of-a-kind specialty retail firm that is focused on the healthcare segment—and despite rigorous competition, Walgreens continues to gain strength as the company increases its domestic and global market share. We have stated previously how Walgreens has put the pedal to the metal on

growth, with new acquisitions following the company's 2015 acquisition of Alliance Boots, the leading pharmacy-led health and beauty group in Europe. This past year, Walgreens absorbed 1,474 Rite Aid stores—the original number of Rite-Aid stores acquired was 1,932, but the company closed 458 stores that were unprofitable or overlapped the company's current store footprint. In addition, during 2018 the company completed an agreement with China National Accord Medicines Corporation Ltd. to become an investor in its subsidiary, Sinopharm Holding Guoda Drugstores Co., which operates and franchises retail pharmacies across China. Walgreens Boots Alliance acquired a 40% minority stake in GuoDa through a capital investment of $416 million. GuoDa is a leading retail pharmacy chain in China that operates more than 3,500 retail pharmacies across around 70 cities and employs close to 20,000 people.

Walgreens also owns 56,854,867 of AmerisourceBergen common shares, representing approximately 26.8% of the outstanding AmerisourceBergen common stock. In addition, Walgreens can acquire up to an additional 8,398,752 AmerisourceBergen shares in the open market. This strategic investment provides Walgreens an opportunity to vertically integrate its business via a future option to purchase one of the largest drug wholesalers in the industry (the other two are McKesson and Cardinal Health).

Under the leadership of Stefano Pessina, Walgreens management team is successfully integrating and transforming the traditional drugstore and creating a company platform for selling and distributing healthcare products to well over one billion people located in 11 countries, through more than 18,500 owned and affiliated stores and more than 390 distribution centers. Walgreens Boots Alliance has an integrated, global drug distribution platform that is unmatched—providing this company a "first mover global advantage." The combined company is one of the largest purchasers of prescription drugs in the world, giving it more leverage in negotiating with drug suppliers to lower costs on the annual purchase of hundreds of millions of prescriptions.

Regarding the potential threat of Amazon in the drug retail and/or wholesale space: As we stated earlier, Amazon has entered this space through its acquisition of PillPack, and now we are off to a competitive race in this industry. At this point, we should note that Walmart and Target attempted to enter this industry but ultimately failed to make an impact. Why? The drug wholesale and retail businesses are very difficult to compete in and require a company to make large strides in quickly scaling the business. Although this is very possible given Amazon's tremendous success in disrupting other retail segments, the healthcare industry holds special challenges. Regulation is extensive, the industry is consolidated among a few players at the wholesale and retail level, the networks are extensive, and the profit margins are already very thin. In other words, entering this industry is not the same as entering a fragmented retail industry (think: Sears, J. C. Penney, and Macy's), purchasing goods from manufacturers at low prices, and then creating a venue to sell items at a discount through the Internet. The drug retail and distribution business already offer similar opportunities for individuals and organizations to purchase drugs. We believe that Walgreens will do better than survive and will continue to thrive as a leader in the complex, global healthcare market. (However, we will maintain a watchful eye on Amazon's progress in the healthcare industry).

We expect Walgreens Boots Alliance to continue increasing in value as the company takes advantage of ongoing industry consolidation, while maximizing productivity and efficiencies and emphasizing unmatched customer and patient healthcare services through its stores and partnerships. The combined global entity will continue to expand product selection at affordable prices and interconnect the global in-store and online retail experience to create a specialty healthcare business that is different and unmatchable. We believe that the Walgreens Boots Alliance of the future is shaping up to be much more than a typical retail pharmacy. The company's planned evolution to offer global consumers a more integrated package of healthcare services promises to create significant value for shareholders.

Walgreens Boots Alliance produced positive results in 2018, with U.S. retail and international retail comparable store sales growing 1.2% and 4.7%, respectively. The company had adjusted earnings of $5.05 per share in its fiscal year-end, August 2018, and should grow earnings at approximately 16% in fiscal 2019, to $5.86 per share. We continue to be excited owners of this emerging global healthcare franchise and expect terrific results in the future.

MEDIA & COMMUNICATIONS GROUP

The media and communications businesses continues to be a challenging investment area—the industry remains extremely competitive and dynamic due to its reliance on changing technology infrastructure,

including internet and cable. Due to the vast and growing number of channels available for content distribution and the multiple mediums through which consumers can access entertainment, it is paramount that media companies create and distribute "great content" to attract customers and advertisers. We know of no other business in which a customer or advertiser can switch loyalty as quickly as in the media business. And a migration in advertising revenues to new emerging media companies continues to accelerate due to the disruption of "streaming content" in this industry—e.g., Amazon Prime, Netflix, Hulu, etc. As a result, several legacy content providers that mostly rely on advertising revenues to drive profitability continued to struggle with fairly static revenue and earnings generation in 2018. Clearly, it is important to choose media companies that have a special grip on the marketplace by producing exceptional content that attracts various advertisers despite the disruption created by services such as Netflix and Amazon Prime. In this category, we continue to hold what we consider to be the best media business in the industry: Disney.

Walt Disney Company

Disney is the one business that we place in the "invaluable" category due to its unique franchise. The invaluable nature of Disney is based on its different and unmatched content (films, characters, etc.) that is analogous to an oil well that keeps producing indefinitely after incurring an initial development expense. Each time the company develops an animated or iconic film, much of the film development is expensed at the time of its introduction. In future years, when the company re-launches these classic films in updated formats (DVD, 3D, and soon: virtual reality), Disney attains additional revenues and profits without incurring the original development costs. We refer to these re-launches from the company's film library as "accessing the Disney vault." That the content of this vault consists of gooses rather than golden eggs is an important investment point—the magic gooses keep laying golden eggs—e.g., *Snow White and the Seven Dwarfs, Pinocchio, Bambi, Cinderella, Alice in Wonderland, Peter Pan, The Little Mermaid, Beauty and the Beast, The Lion King, Aladdin, 101 Dalmatians, Frozen, etc.* We can envision our grandchildren's grandchildren watching many of these classic Disney films in the new millennium, no matter what future medium the content is delivered on. The value of the Disney vault is incalculable because of the 100-year annuity associated with placing new iconic films in this facility, as well as reissuing previous Disney films as novel delivery mediums emerge, and new generations of children—future viewers of these movies—are born each day.

Disney's current CEO, Bob Iger, and his management team continue to do a remarkable job creating shareholder value. Mr. Iger has maintained the company's culture and focus while expanding Disney's invaluable library of content, broadening its distribution network, and embracing new technologies that complement and enhance the Disney experience. In addition, under his leadership, new film franchises (i.e., golden gooses) are being added to the Disney vault through the company's creative team, which is unmatched in both animated and unanimated film. During 2018, Disney launched *A Wrinkle in Time* starring Oprah Winfrey, *Incredibles 2*, and *Mary Poppins Returns*. In the upcoming year, Disney is introducing live-action films of classic characters*: Dumbo, Aladdin,* and *The Lion King*. *Toy Story 4* and *Frozen 2* are also set to launch during the upcoming year—we expect Disney's film division to do very well at the box office in 2019.

During 2018, Disney agreed to acquire certain entertainment assets of Twenty-First Century Fox for $71.3 billion in a 50/50 cash-and-stock transaction. This deal includes Fox's film/television assets; FX and National Geographic channels, the regional sports networks (regulation will require that this be sold by Disney after the transaction is completed), Fox international networks and STAR India; as well as the FOX's minority stakes in Hulu (30%) and Sky Plc. (39%)—Disney will sell its Sky stake to Comcast for about $15 billion. This deal is a game-changer for Disney, as it creates a platform for Disney to offer vast content on its own streaming platform. Given the changes occurring in the media industry, the distribution of content to consumers has been widened—offered through various channels as consumers wish to stream entertainment content on any device, anywhere, at any time. With the content acquired via the Fox deal (due to be completed in early 2019), Disney can now better compete effectively in an ever-changing media landscape.

We believe that Disney has stronger long-term growth prospects than most investors realize due to the company's highly competitive position in the media and entertainment industry. In addition, Disney's broad range of content offering and growing international presence will allow the company to extend its global reach for many years to come.

Disney earned an adjusted $6.75 per share in calendar 2018, an 11.75% increase over the twelve-month period in 2017. The company is expected to grow earnings at approximately 7.25% in calendar 2019, to $7.25 per share. Disney will generate around $9.5 billion of owner earnings in the upcoming year, and is expected to

return a large portion of this cash to stockholders through share repurchases of approximately $5 billion and dividends of $2.6 billion. We remain enthusiastic owners of Disney, as the company continues to expand its global franchise, adding value for shareholders.

Liberty Global

In early 2017, we made a commitment to Liberty Global. It is natural to ask: Who and what is Liberty Global? Liberty Global plc is the world's largest international television and broadband company—think of Liberty Global as the Comcast of Europe. Liberty Global is focused on building a strong convergence of fixed and mobile communication opportunities and constantly strives to enhance and simplify customers' lives through quality services and products that give them the freedom to connect, converse, work, and be entertained anytime and anywhere they choose. Liberty Global has consolidated operations in 12 European countries serving approximately 22 million customers. The company's primary business operations include Virgin Media in the United Kingdom and Ireland; Unity Media in Germany; Telenet in Belgium and Luxembourg; and UPC Holding in Switzerland, Austria, Poland, Hungary, Romania, Czech Republic, and Slovakia.

Although the cable business is a good business, since our purchase of Liberty Global at the beginning of the year, this stock has underperformed the market. Why has it underperformed, and why did we purchase Liberty Global?

When we purchased Liberty Global at the beginning of 2018, our estimated value of the company exceeded the basic purchase price. Our valuation of the business was based on looking at the individual areas in which Liberty Global competes and assessing the worth of each division. We felt that Liberty Global would eventually monetize its fragmented assets and sell off various divisions to other companies that could leverage the entities to better compete in local markets.

This thesis did play out on May 9, 2018, when Liberty Global reached an agreement (called the Vodafone Agreement) to sell its operations in Germany, Romania, Hungary, and the Czech Republic to Vodafone Group. The cash proceeds that Liberty Global will receive from this transaction will be calculated on the basis of the agreed enterprise value adjusted for the net debt and working capital of such businesses as of the closing date of the transaction, as well as other post-closing adjustments. Based on the net debt and working capital of the acquired businesses, the cash proceeds would be approximately $12 billion to Liberty Global. The closing of the transaction is subject to various conditions, including regulatory approval, which is not expected until mid-2019. Now here is the issue that has impacted the share price of Liberty Global: Regulatory approval is not certain, although we believe the chances of this transaction being approved is above 80%.

When looking at the market value of Liberty Global today—at approximately $15.7 billion—and the fact that the company will receive approximately $12 billion of proceeds from the sale of its operations in Germany, Romania, Hungary, and the Czech Republic, we believe the value of the remaining company assets is significantly higher than the difference between Liberty Global's year-end market value of $15.7 and the $12 billion of cash to be received from this transaction, or $3.7 billion. In addition, Liberty Global is evaluating the sale of its regional operations in Switzerland that would be better placed in a stronger competitor's hands.

In summary, on its own, Liberty Global is a tremendous cable franchise in Europe, especially in the United Kingdom and Ireland. In our opinion, the sum value of its operating parts far exceeds the company's current market value, and we will remain patient as we are confident that the large disparity in value perception will close. In the meantime, Liberty Global has is utilized its approximately $1.6 billion of free cash flow during 2018 to purchase its stock at low prices. The company acquired around 8.5% of its outstanding stock this year, and this further enhances the per-share intrinsic value for shareholders between now and the time the Vodafone deal is approved and completed. We plan to remain shareholders of Liberty Global as the company refranchises its operations and monetizes its various assets to maximize shareholder value.

FIXED-INCOME INVESTMENTS

The Barclay's U.S. Aggregate Bond Index, which represents the broad debt market, experienced no gains in 2018. We have emphasized in the past few years that the heyday for high fixed-income returns has passed and that investors pouring money into bond funds since the financial crisis of 2007-2008 were likely to be disappointed—and this is beginning to happen. Unfortunately, many individuals missed the current opportunity for financial gain in equities, opting instead for the perceived safety of chasing elusive returns in the credit market. We feel as strongly today as we did when we first wrote about this: Investor complacency in the fixed-income market has lingered for a longer period of time than we had anticipated (though this phenomenon is not unusual), and the bond market remains in "bubble territory." *Let the buyer beware.*

When evaluating the current fixed-income market, we believe people would be *far* better off taking a business approach to investing. We reiterate: If people stepped back and looked at their fixed-income investments in a similar manner to investing in a business, they would become skeptical about their future returns.

Let's say that a business with zero debt is able to produce a steady 10% return on equity. If management elects to retain the annual earnings of this business and plow the funds back into the company, investors can expect to see their "equity bond" double in a little more than seven years.

Now let's look at a bond in a similar business light. If you purchase a bond at par that produces a 10% tax-exempt coupon and choose to retain the annual earnings from this bond and reinvest the money into the same bond at par each year, you will also double your money in a little more than seven years—producing a similar result to our business example.

Based on this example, it is our opinion that people purchasing bonds today are not applying a business perspective, despite the steadfast low interest rate environment. For example, putting aside tax implications, if we purchased a 30-year U.S. Treasury bond on December 30 at a 2.68% yield (the year-end yield was 2.74% on December 30th, 2017) and chose to reinvest the coupon payments into those same bonds at par, doubling our money would take approximately 26. If we presented our clients with a similar arrangement to invest in a business that produces a 2.68% return on equity and retains all the proceeds to repeat this poor return, our judgment would be severely questioned, regardless of whether the business was assured survival. Unluckily, today's absolutely abysmal return of 3% on a 30-year U.S. Treasury bond is guaranteed to lose money against inflation that may average over 3% the next 30 years (we will once again refrain from any forecasting). Nevertheless, many financial managers and individuals who adhere to traditional rules of asset allocation to fixed-income instruments continue to place a greater-than-average portion of assets in *un*businesslike opportunities. (This does not mean that bond prices will never rise—investor panic and/or deflationary pressures can attract additional money to fixed-income investments in the future, even at low yields.)

We continue to emphasize several points that concern us about fixed-income instruments: Besides the ongoing poor returns being generated in this area, looming risks associated with this "secure investment vehicle" include ongoing rising interest rates (which are on the table again for 2019) and even greater chances of default. We remain concerned about low long-term market interest rates, which are destined to move upward as the Federal Reserve desires to change direction on maintaining a low interest rate environment as economic conditions remain positive (low inflation and low unemployment). As the economy continues to grow, the Federal Reserve has stated its intention to continuing to raise short-term interest rates—we shall see how this plan develops. Ultimately, the Fed's action to raise interest rates will put continued pressure on the value of fixed-income instruments as well as other interest-sensitive assets. Although many predict that fast-rising interest rates are in the distance, our experience with other prophecies should illustrate that the crowd is often wrong. Market interest rates could unexpectedly move upward at a faster rate than intended, which would place tremendous pressure on low-yielding, long-term fixed-income investments.

In 2019, we have ongoing tranches of municipal and corporate bonds coming due. We will elect to reinvest the proceeds in shorter-term fixed-income instruments—largely U.S. Treasuries bills going out six months—unless we can find a worthwhile fixed-income securities alternative allocation that will provide a fair return over a longer term. In summary, we will maintain a businesslike attitude about our fixed-income investments, carefully allocating money to securities that offer a fair risk and return over the duration of the holding.

* * *

WHAT'S NEW AT FOUNDERS?

As stated previously, this past year has been difficult for all of us at Founders due to Jon's sudden passing, and this tragic event accelerated a long talked-about transition within our firm. We all miss Jon terribly, feeling his presence every day, and are moving forward as he would have liked us to move forward—having faith in ourselves, and with our clients first in our hearts and minds.

Jon felt that faith in what we stood for was a necessity for success. In our collective view, faith translates into the trust, belief, confidence, conviction, optimism, and hope surrounding the value (able) guiding principals emphasized within our firm every day. These ideals that define our organization will continue to fuel our efforts to deliver success for our clients.

During the past 18 months, our firm has been fortunate to have individuals join us that *have a rock-solid value system*. We all recognize a "good value system" when we see it, though it can be a hard thing to describe. In our view, a good value system goes well beyond honesty and integrity (both of which are "musts") to include a caring nature that puts others' interests before one's own. This character trait is rare, and it makes a difference. So, the first concept in developing a permanent culture is "hiring for heart." Founders seeks individuals that aspire to work together in an environment in which we care for each other and place our clients' interests before our own. We are all lucky that Lisa, Ted, and Jeff have joined our firm – they all have heart.

Transparency is paramount to success in any partnership. We remain committed to full transparency with our clients and with each other, and we are intent on communicating openly and fully with clients—the purpose of this letter. In addition, we believe that we all (our clients and associates) have a desire to be happy—an elusive and sometimes challenging concept. Repeating a story from the special mid-year letter: Our family was having a discussion about happiness around the patio table one afternoon, and my eight-year-old granddaughter piped in on the adult conversation, declaring, "I would rather be hopeful than happy." Not fully grasping her wisdom, I asked her what she meant. She explained that when someone tries to be happy, then they become happy. I took her insight to mean that happiness is obtained through what one strives for and how one conducts oneself over life's ongoing journey—basically, she told her Papa not to think of happiness as a destination, but as a product of life's great journey.

Each of us at Founders Capital Management remains grateful for your business and faith in our stewardship. We can't thank you enough for the opportunity to serve you and for your continued trust. We look forward to working with you and continuing our shared journey in 2019.

The examples and descriptions of investments in this client letter do not represent all of the investments purchased, sold, or recommended by Founders and instead represent:

1. *the 10 largest equity positions held by Founders' clients;*
2. *the two largest equity positions in each industry group to which Founders has allocated capital; and*
3. *all equity positions that account for 3% or more of the total funds allocated by Founders to equity holdings.*

The performance of these investments was not a criterion in determining the representative list. It should not be assumed that the investments identified and discussed were or will be profitable.

The views expressed in this report represent the opinion and analysis of Founders Capital Management based on data available from public sources at the time of writing. This report is not intended to provide any recommendations with respect to the purchase and/or sale of any specific security. It is recommended that individuals conduct their own research or consult with an investment advisor prior to making any investment decisions.

APPENDIX

Founders Company and Investment Culture

What Do We Focus On?

- **Act as business owners for the long haul,** as opposed to looking at investments as "paper to be flipped"
- **Act with "Rs: in mind: Reputation** (never lose it), **Responsibility (**always take it), **Reliability & Results (**focus on execution)
- **Act with character**—it's hard to describe, but we know it when we see it. When in doubt, always place others' interests before one's own
- **Practice "mindful investing,"** fully understanding where our money is invested, as deep down as we can observe. Take complete responsibility for allocating capital, and do not abdicate money management and research to others
- **Understand the value of our held assets,** both those that are directly held and any investment with underlying assets
- **Care for clients and for each other**—collectively, we are Founders' greatest assets
- **Invest our own money as we invest for clients,** ensuring that we "eat our own cooking"
- **Maintain a human growth orientation**—for individuals and clients over revenues and profits. Size does not matter, but growing knowledge and embracing quality does. Enrich the lives of those we interact with.
- **Seek and generate ideas, and learn from mistakes**—because mistakes are bound to happen—face them, and don't sweep mistakes under the rug
- **Learn to learn**—think different and unmatchable, and become an organizational "learning machine"
- **Share knowledge**–hoarding knowledge is like hoarding love—the more you keep it for yourself, the more you lose it
- **Think in questions vs. answers**—insightful questions leads to greater intelligence and create options for decisions
- **Remember that the will to prepare is more important than the will to win**

How Do We View Risk?

- **Seek spread, safety, and certainty in our investments**—when practiced, speculation is eliminated
- **Always remember security:** purchase what is dependable / defendable and predictable / protected. Analyze the potential loss before gain and focus on scenarios that can go wrong with an investment
- **Observable Risks**–"See What Others See"
- **Identify developing risks**–Aspire to see what others may not see, including risk creep, aggregation risk, and potential events that can cause financial fragility
- **Allow for Unavoidable Uncertainty**–expect the unexpected, as the unexpected is certain to happen
- **"Remember to be Humble, Aware, & Careful"** –Acknowledging what we don't know is the dawning of wisdom
- **Risk Sensitivity = "Margin-of-Safety**"—Be mindful of valuation and interest rates, capital structure and liquidity,

franchise, business model, and management risk.

- **Remember that the greatest risk is not fluctuation in the stock and bond markets—**the largest risk resides in purchasing lower-quality issues that look good today but in the long run face erosion in real value.

- **Always avoid dealing with people of questionable character**—we will be associated with the company we keep. Remember that reputation and integrity are our most valuable assets—and can be lost in a heartbeat

How Do We Invest?

- **Focus on absolute over relative returns:** The investment world is full of illusory short-term comparisons that ultimately lead to permanent loss. Be risk-adverse, and abhor losing money under any circumstance
- **Seek industry and business ecosystem insight** vs. making macro predictions on the economy or market, which are certain to be wrong
- **Don't develop a master plan when investing**—be situation-dependent and opportunity-driven
- **Avoid unnecessary transactional taxes and frictional costs**—never take action for its own sake
- **Enjoy the investment process**, because studying and researching business is where we live
- **Recognize and adapt to the nature of the investment world**; don't expect it to adapt to us
- **Continually challenge and willingly amend the "best-loved investment ideas"**
- **Recognize investment reality even when we don't like it**—perhaps especially when we don't like it
- **When investing, think multidimensionally and look at investment from all angles**—this is captured by the quote "Invert, always invert"
- **Develop disciplined thinking around investment spreads**—always seek to maximize cash yield spreads and practice short-term and long-term arbitrage
- **Utilize 2nd- and 3rd- level thinking when investing**–always ask, "And then what happens?"
- **Develop "deep insight" and focus on value**—discern the truly valuable from the illusory
- **Remember the key elements to company evaluation**–Understand the "industry ecosystem", describe the "investment insight"—including the company's competitive advantage, its strategic position within the industry ecosystem, and the potential disruption that could erode the company's sustainability
- **Decipher the difference between certainty and uncertainty**–understand the difference between what is knowable and important, unknowable and important, and unknowable and unimportant. Place a high value on a probable certainty of outcomes

- **NEVER SPECULATE IN ANY INSTANCE** – FOR THIS IS AN RECIPE FOR EVENTUAL FAILURE

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