Lessons Learned

FOUNDERS CAPITAL MANAGEMENT
2019 ANNUAL REPORT

FOUNDERS
CAPITAL
MANAGEMENT

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

2019 Annual Report:

"Lessons Learned"

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PRINCIPALS' LETTER
From: Founders Capital Management

"Lessons Learned"

"I have never let my schooling interfere with my education."
—Mark Twain

During 2018, market volatility shook many investors to the point of no return—by the end of the year, many individuals had sold their holdings, opting to wait for a time when calmer markets would prevail. A different story emerged in 2019: The market rose quickly, leaving sidelined investors behind. Over the past 12 months, the opportunity to enter the market at a stable time never occurred, since most stocks underwent persistent gains. Once again, many investors' wariness about volatility superseded their ability to rationally evaluate the businesses in their portfolios. Fixated on price movement, these sidelined investors "knew the price of everything but the value of nothing." This Pavlovian response to market volatility leads to angst—the investor becomes a gambling stock trader and, as a result, opportunities to invest in good businesses are ignored, securities are prematurely sold, and potential future returns are lost forever.

We continually remind individuals to act as investors as opposed to speculators, and to remain focused on the businesses they own, regularly evaluating those companies' positions in the marketplace and how management is creating long-term value for owners.

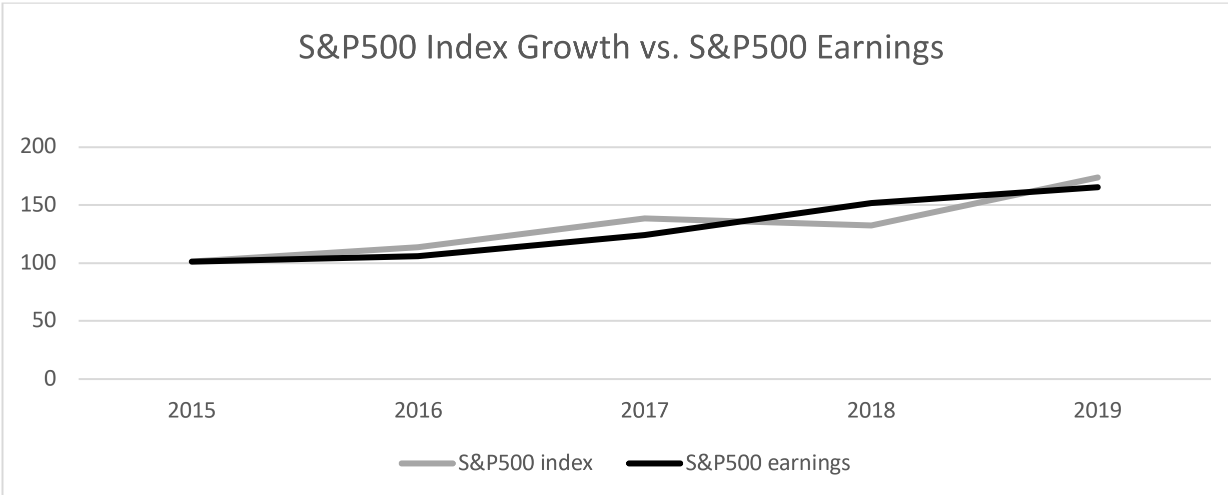
Too many individuals fail to heed this advice, focusing instead on questions that have no available answers: Where is the market heading? When is the recession coming? When will the next market crash hit?

This letter does not attempt to answer these questions—we do not have any better ability to provide answers than any other investment professional. This year's letter is, however, a concerted effort to share the lessons in business and investing that we have learned over the years, including the past year—we never stop learning!

This year's letter marks a turning point for Founders: I am no longer the sole author, now sharing this annual reflection of the past year's journey with Jeff and Ted. Much of what you will read in the following pages represents our collective thoughts. We will not specify the contributions of any one individual; rather, the information in this letter represents the composite viewpoint of a united firm focused on maximizing the long-term returns on our collective holdings. In closing this introductory section, I am compelled to express my gratification about the fresh talent at Founders that is effectively broadening our investment horizons.

* * *

In our 2018 letter, we referred to the year's market loss as a time of absorption. Conversely, 2019 was a year of a large market recovery. The roller coaster market ride of the past few years is enough to make anyone wonder whether it pays to be involved in the stock market. Every day seems to bring disruptive news that acts like a strong wind, accelerating the market's price movement—up and down. This stock market price whipsaw can be exhausting to anyone participating in the market—even professionals. When we step back and evaluate the longer-term trend of the market, however, we can see that its movement overall indicates strong gains in intrinsic value over time. For example, the following chart compares the gains in the S&P 500 over the past five years to the index's increase in earnings over the same time frame:



During 2015, 2016, and 2017, the S&P 500's total return was 1.4%, 12%, and 21.8%, respectively, followed by a -4.38% (negative) return in 2018. ***During 2019, the S&P 500 total return rebounded with a 31.49% gain.*** If we had placed $100 in the S&P 500 index at the beginning of 2015, that investment would have turned into approximately $174 dollars at the end of 2019—reflecting an annual return of approximately 11.7% over the past five years. Now, let's look at the steadier growth in earnings for all companies in the S&P 500. Over the same five-year time period, the S&P 500 index's collective earnings grew from approximately $100 to $165 per share, reflecting a 10.5% annual increase. Despite the S&P 500 index's seeming "price gyration" over the past five years, overall, investors realized gains that nearly mirrored the increase in earnings of the companies that make up the index. (As a side note: S&P 500 collective earnings are forecasted to rise around 9% in 2020, to approximately $180—a higher expectation likely explains the slight difference in the market returns versus earnings growth the past five years, as well as the rise in the market this past year).

The question investors should be focused on: What are the anticipated gains in earnings among the companies that collectively make up the S&P 500 index over the next five and 10 years? The answer to this question is more knowable and important than unknowable answers to questions such as: "Where is the market heading in 2020?" Or "When should we anticipate the next recession?" We understand that these questions are borne of angst from political and economic headlines. The market impact of Brexit and financial pressures in Europe; ongoing challenges in the Middle East; negative interest rates in developed economies; trade skirmishes involving America, Europe, and China; and the upcoming 2020 U.S. election are just some of the newsworthy concerns that plague investors and gyrate short-term market prices.

As we have stated previously, these factors may or may not contribute to future economic (and market) disruption, and believing they would cause certain market setbacks in the future is likely misguided. In our view, ***the market's long-term returns will ultimately be tied to growth in the global economy and the prospects of its underlying companies***. We still see favorable global economic conditions for the foreseeable future, and we believe that participating businesses will continue to flourish. We realize that economic and business gains sometimes outpace market gains, while at other times the reverse occurs. We also understand that pundits will always 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—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.

Many investors get caught up in short-term news (both positive and negative) that activates emotions and drives their market behavior—e.g., holding off on placing new money into the market, excitedly speculating on newly issued stocks with the hope of rapidly increasing their wealth exponentially through these "bets," or anticipating imminent gloom and removing money from the market before the "inevitable setback" happens. The key concept here: Human beings are wired to take immediate action based on short-term emotions. The challenge of managing our natural human impulse to react to short-term emotions is illustrated in a famous experiment—the Marshmallow Test. (It should be noted that this experiment has been disputed since it has not been replicated; nevertheless, it provides a useful metaphor):

In the 1960s Stanford Marshmallow Test, children were brought individually into a private room, where they were invited to sit down in a chair, and a marshmallow was placed on the table in front of them. The researcher offered the child a deal: He told the child that he was going to leave the room, and that if the child did not eat the marshmallow while he was away, the child would be rewarded with a second marshmallow. However, if the child decided to eat the marshmallow before the researcher came back, he would not get a second marshmallow. The choice was very simple: One treat right now, or two treats later. The researcher then left the room for 15 minutes. We can imagine four- and five-year-old children sitting alone in a room, looking at a marshmallow directly in front of them. Of course, some kids jumped up and ate the marshmallow as soon as the researcher closed the door. Others stared, wiggled, and bounced in their chairs as they tried to restrain themselves but eventually gave in to temptation before the researcher returned. And finally, a few of the children did manage to wait the entire time, earning a second marshmallow. The interesting part of this experiment came decades later, after researchers had been tracking over a 40-year period specific "life success" metrics of the children who had participated in the Marshmallow Test. What they found was surprising: The few children who had been willing to delay gratification and waited to receive the second marshmallow ended up having higher SAT scores, lower levels of substance abuse, lower likelihood of obesity, better responses to stress, better social skills as reported by their parents, and generally better scores in a range of other quantifiable aspects of life. In other words, the marshmallow series of experiments correlated the ability to delay gratification with success in life.

Now, let's apply the principles of this experiment to participation in the stock market, which is made up of thousands of marshmallows that create emotions that will drive potential gains or losses in wealth.

Like the children whose response was to impulsively eat the first marshmallow, most individuals approach the stock market like "hungry hunters"—attracted to stocks they think will rise the fastest and enable them to make a "quick killing." These tempting marshmallows act as a magnet for participants who desire to gain fast money. Similar to gambling on a slot machine, some individuals get carried away by their emotions—they repeatedly gorge themselves with hunted marshmallows, in the grip of an emotion-powered vision of achieving great wealth. Sadly, most individuals who practice this approach to the stock market end up getting sick and never touching another marshmallow again (some go broke).

Now, to be fair, there are cases of investment professionals that have made money trading hunted marshmallows. A (very) small group of successful hedge funds over the past 30 years have built excellent investment track records based on market insight—for example, by employing complex mathematical algorithms that use historical data on market volatility to successfully predict various short-term economic and company events. These algorithms literally "hunt" for short-term disparities that have occurred due to predictable market overreactions to company earnings or economic news (both positive and negative), producing computer-driven short-term bets that can lead to market-beating returns. Unfortunately, those few successful hedge funds blossomed into a hedge fund industry that now includes more than 8,000 players managing $3.25 trillion dollars—which represents more than 30% of daily stock market trading, according to the research firm, Tabb Group. The track records of these thousands of hedge funds applying various methods to hunt marshmallows that will achieve market-beating returns have been less than stellar. Initially, the hedge funds followed a similar strategy of exploiting market emotions based on events that had already occurred—whether using computer algorithms or human intuition. A reversion to less-than-the-mean occurred, however, when competing hedge funds tried to differentiate by altering algorithms or intuitively *anticipating* market emotions based on *guessing* about potential upcoming events. The initial hedge fund strategy is more knowable, while the second is unknowable. Thus, the average hedge fund produced less than half the returns of the S&P 500 in 2019, and over the past 12 years, collectively, these marshmallow-hunting dynamos have greatly underperformed the market averages.

A story to illustrate our point about delaying gratification in investing: In December 2007, Warren Buffett made a bet with a money manager: He offered the money manager the opportunity to pick five funds-of-funds (groups of hedge funds) in which to invest $500,000 in client funds; the results would be compared to a low-cost Vanguard S&P 500 fund over a 10-year investment period. The money manager chose five funds-of-funds managers that invested in more than 200 hedge funds. It should also be noted that the funds-of-funds managers were allowed to change hedge funds at any time to maximize their portfolio returns. This dispersion made sure that the overall performance of the funds-of-funds would not be distorted by the good or poor results of a single hedge fund. After 10 years, the results were as follows: The S&P 500 index experienced a compounded annual increase of approximately 8.5%, while the chosen hedge funds averaged an approximately 2.9% annual return. And so, an investor who had placed $1 million in the S&P 500 index would have had $2,260,983 at the end of the 10 years, whereas $1 million placed among various hedge funds would have been worth $1,330,925. Put another way: $930,058 of investor money was "lost" to a combination of underperformance and hedge fund fees that included annual charges of up to 2% of total assets managed, plus 20% of portfolio profits. The point here is that even professionals using complex, artificial intelligence-driven algorithms do not impose the delayed gratification that is critical for overall investing success. Greed is an ingrained human emotion that is built into their models of trading frequently to make a quick profit.

Similar to the few children who were able to delay their gratification by forgoing the one marshmallow, waiting patiently so that they could walk away with two—individual and professional market participants who exercise the discipline to purchase and hold a select number of companies over the long-term are rare.

The Lesson of Farming and Hunting

Over the past few decades of studying, participating in, and practicing investing, we have had the opportunity to learn and hone our skills. One of the most important lessons we have learned during our journey is the distinction between hunting and farming. In the previous section, we considered how hunting for immediate gratification when investing can prove perilous. Of course, most individuals naturally start as investment "hunters," seeking the quickest gains and jumping from one investment to another. Eventually, they learn that reaching too hard for wealth leads to stumbles and some very hard falls—like a baby just learning to walk who too quickly decides to run. They learn another lesson: If investing were as easy as viewing "hot stocks" and jumping from one investment to another, every market participant would be rich—but we all know that this is not the case, as few obtain sustained wealth.

True investing is hard work, and more like farming. We can imagine the hunter that pursues its prey, attains its capture, indulges in the conquest, and moves on to the next target. The emotional exhilaration of victory drives the investment hunter to repeat the process—like an addicted gambler. The farmer, on the other hand, practices the opposite. The art of farming involves tilling the soil, planting seed, and weeding and watering the crops. It entails a series of daily cultivation chores that will maximize the long-term harvest. Investing is like farming—the participant needs to study various companies within several industries (till the soil), invest capital in a select number of businesses (plant seeds), remove and acknowledge mistakes when they occur (weed the portfolio), and constantly add capital to great businesses when the price is right (water the plants). Harvesting wealth is also an important part of the investing process, as it needs to be done in a tax-efficient manner (we will cover this later). Since our founding, we have practiced attentive investment farming, and this will never change.

We also believe that you can't be a good investor without being a good businessperson, and our experience in business attracts us to companies that also practice "attentive farming." Disney is an example of a company that continuously cultivates value for consumers and shareholders. This company tills the soil by turning over great media content that expands its business worldwide, including the addition of new parks and media distribution methods. Disney plants new content seeds that will appeal to different cultures and demographic groups, ensuring new consumers as the global economy develops; and the company continues to weed out any content that will disrupt its image as a family-oriented and community-spirited company. And finally, Disney expertly harvests its content by reissuing it in many forms as technology evolves, in contrast to other media companies that attempt "land grabs"—"hunting and killing" for new subscribers by offering any content that will win them immediate viewership. These companies spend enormous amounts of capital and employ questionable accounting practices that make them look profitable today, when in reality they are losing billions of dollars—and their stock prices keep rising.

Former companies that have practiced abusive hunting techniques include Enron, which went out of its way to hunt for energy contracts that were questionable, attempted to corner the energy market in certain areas, and killed competition in the process, impacting entire communities. Enron eventually collapsed and went bankrupt; investors lost a fortune. In the pharmaceutical industry sector, Valeant Pharmaceuticals perpetually hunted for acquisitions. Once secured, Valeant killed R&D expenditures and exponentially raised their drugs' prices. In the short term, the company was a "cash machine," becoming an investor's dream—and the company's stock price skyrocketed. Eventually, regulators and the investment community caught on to the abuses by Valeant and its executives; the company nearly collapsed, and stockholders lost a fortune.

These examples distinguish "farming" from "hunting" companies. Notice that capitalism works when bad actors are weeded out and rejected by the system. It is important to ensure that companies operating in a capitalistic system behave in a socially responsible manner and, when they do not, the system must reject the abusive participants, and investors that propped them up should lose money. In addition, regulators must act as vigilant arbiters upholding the laws that allow our capitalist system to continue enriching our country and a large majority of citizens.

Today's Capitalism

A 2019 Gallup poll revealed that 43% of Americans favor socialism over capitalism. In contrast, in 1942, 40% of Americans stated that socialism would be bad for the country, while the majority of Americans favored capitalism. Rather than jump in with an opinion about why capitalism is negatively perceived by a greater percentage of Americans today, we'd like to step back and ask why this reversal has occurred.

First, what is capitalism? A common definition: "Capitalism is an economic system based on the private ownership of the means of production and the operation for profit. Characteristics that make up capitalism include private property, capital accumulation, wage labor, voluntary exchange, a price system and, most important, competitive markets." The essence of capitalism is competitive warfare for the finite consumption of goods and services—it is Darwinian in nature, and only the smartest and strongest survive. In most cases, the spoils go to the few.

Most people are naturally repulsed at the thought of capitalism being a process of warfare in which businesses or individuals compete heavily until there are a few ultimate winners. Its unfairness resonates; capitalists are viewed as predators that hunt for a greater-than-average portion of society's wealth. That aspects of capitalism can be viewed as ruthlessly Darwinian is regrettable, given that its original concept was to serve as a collective structure for interdependent businesses (and individuals) to cooperate in a way that brings value to each other. Capitalism and cooperation are in our nature, and its success is contingent on farming and cultivating rather than on hunting and warfare.

From the early days of our human species' evolution, Homo sapiens developed a culture of cooperation. We survived against great odds based on working together, eventually developing the cooperative system of farming and agriculture as opposed to relying solely on hunting for food. In contrast, our brethren human beings, the hunting Neanderthals, went extinct. In essence, we are biologically "wired" to cooperate for our collective survival. This was to be the essence of capitalism—a competitive system, yes—but largely intended to be a cooperative, interdependent structure for businesses and individuals to achieve success via a collective tending to customers, employees, and the community. Socialism, on the other hand, arose in reaction to capitalism's skewed wealth distribution (unfortunately, capitalism does not provide an "even" distribution of wealth throughout society). In contrast to capitalism, socialism is an economic and social system that advocates that the means of production, distribution, and exchange should be owned or regulated by the community as a whole and usually involves one body (usually a government, king or queen, or dictator) that decides how to allocate wealth evenly among all constituents. This noble "concept of fairness" has been tried for centuries (through feudalistic, socialistic, and communist governments and regimes) and has been proven time and again to be impractical, given its essential incompatibility with human nature. Socialism is not free cooperation and interdependence. It is a construct of enforced dependence on a single entity, led by a few, to allocate wealth fairly and evenly—which becomes difficult to execute given our species history. In fact, in the majority of societies that have pursued socialism, the spoils have gone to the *few* who controlled the system. Nevertheless, over the past few decades, the U.S. has admittedly gone astray from the original construct of capitalism, whereby the intent was for wealth to be distributed more equitably. Over the past few decades, as wealth has continued to accrue to fewer and fewer participants, negative views about the capitalistic economic and political construct have grown.

Our research, observation, and experience at Founders over the past few decades have led us to believe that sustainable capitalism is achieved when successful businesses practice farming over warfare—cultivating cooperation among their employees, customers, and the community. We are ardent fans of this approach and endorse this practice.

An Additional Lesson on Capitalism: Hunting the Wealthy or Farming for Taxes

To be clear, we do not support abusive behavior in a capitalist system which, by its nature, can be ripe for abuse in the absence of laws and regulations that are enacted and strictly enforced. As close participants in capitalism, we have the opportunity to see things that others may not. For example, we collectively read some 1,000 annual reports each year from various companies spanning most industries. A common theme we see in virtually all company reports is what we consider to be egregious compensation packages that can add up to an average giveaway of up to 10% of a company's earnings through stock option and stock grant programs to selected employees, middle and executive management, and board members. (In other words, net income from American corporations would be slightly more than 10% higher in the absence of stock-based compensation programs.) Collectively, 10% of adjusted annual net earnings from American corporations (which is approximately $1.79 trillion) equates to approximately $180 billion. A question needs to be asked: What is the intrinsic value of this growing $180 billion wealth transfer that takes place each year from Americans to employee shareholders? Or, a more succinct way of asking the same question: What percentage of Americans' net worth is being transferred to a select number of individuals via stock-based compensation programs? If the intrinsic value of today's market is approximately $31.5 trillion, then the wealth transfer from the many to the few is valued at approximately $3.15 trillion. (To be fair: Incentive compensation for select executives should exist—some earn their high compensation based on value built for shareholders—so let's say that 50% of stock-based compensation results in a wealth transfer that is "excessive.") Why do we refer to this as a wealth transfer (or wealth tax) on all Americans?

The predominant number of Americans today contribute to 401k (or similar) programs that they will need to tap upon retirement, particularly given that America's social security program is expected to become stressed over the long term. Ultimately, employee-contributed retirement programs place a large portion of the funds in stocks, directly tying this retirement vehicle to America's companies that need to do well today and in the future for retirees to benefit. Incomprehensibly, most company compensation programs are structured today to skim off massive collective shareholder wealth and transfer it to the few—destroying the compounding wealth of Americans' retirement savings. Clearly, the problem today goes far beyond the need to tax the wealthy more equitably. The overarching issue is unfair upfront wealth distribution to a select group. In our opinion, this is not a Democratic or Republican party, liberal or conservative issue—it is a fairness issue. To further illustrate this point: Let's say that future legislation is passed that increases taxes on the wealthy, including individuals that receive a large portion of their wealth through company stock-based compensation programs—there will be cheers across the country. Does one not believe, however, that companies will ultimately alter their egregious compensation programs to compensate for an increased tax burden on executives—i.e., prompting further abuse? In our experience, the answer is likely "yes." Compensation committees made up of CEOs of other companies and/or *un*businesslike board representatives cannot turn on management, as this would be akin to turning on themselves. In addition, the compensation consulting firms hired to compare and develop compensation plans for corporations have a strong interest in maintaining their employment by the incestuous dynamic of the executives that employ them.

Most Americans are not aware of this charade regarding executive compensation, but we have a solution: If a company would like to provide 10% or more of its annual net income to employees as compensation, we would suggest paying them in cash as opposed to stock—then employees could opt to purchase their company's stock at the current market price. This would create a more immediate payment in taxes to the government, and company financial statements would reflect a company's true status. Of course, this move would likely result in lower earnings for all companies, since cash compensation expenses, in most cases, would exceed stock-based compensation expenses due to current accounting methods used to expense stock-based compensation. In addition, this proposed action would negatively impact the value of these companies in the stock market. It would also highlight the egregious compensations paid to company employees, however. This one aspect would likely correct the situation, as capitalism would wield its power when shareholders take full notice and vote down these compensation packages. In the U.S., this will likely never happen, and we all know why: CEO and board director dealings on executive compensation is tantamount to negotiating with oneself while looking into a mirror; you always strike the best deal with yourself. Nevertheless, reversing the ever-growing wealth gap between the haves and have nots in the U.S. will require changes to corporate compensation incentive systems.

The Lesson of Price and Value

In Oscar Wilde's play, *Lady Windermere's Fan,* one of the characters asks Lord Darlington: "What is a cynic?" Lord Darlington's response. "A man who knows the price of everything, and the value of nothing." This answer applies perfectly to another question: "What is a stock speculator?

Many individuals participate in the market as a pastime and, at first blush, investing can seem easy—just read a book or two on investing basics and listen to a well-known investment show that spouts stock picks. Novice market participants quickly fall into the "price quote syndrome," following the "hot stocks" that are rising the most on a daily or even hourly or minute-to-minute basis. They study these quotes as if they are watching a slot machine's step wheels turn, purchasing and selling hot stocks and becoming wide-eyed from the activity. Dopamine pleasures their brain on the wins and, if any losses are suffered, the pleasure-seeking experience eclipses any negative feelings—they are driven to come back for more. They eventually get caught up in the emotional experience, repeating the chase (like a drug addict that needs a fix). This characterization reminds us of Warren Buffett's description of stock speculating, "If you've been playing poker for half an hour and you still don't know who the patsy is, you're the patsy." It seems that there is more speculation going on in the market right now than true investing (an issue we discuss later in our letter). Ultimately, investors that continually practice the art of speculation end up with nothing—just ask the most famous speculator of the past 125 years: Jesse Livermore, who made several fortunes in the early 1900s, only to lose everything several times and ultimately end up with nothing. One must remember that many highly educated professional market participants are hired on Wall Street for their intelligence, and these individuals still fail due to their emotional responses outweighing rational thought.

Understanding a company's intrinsic value and how it is trading in comparison to its market valuation is more important than quoting the company's stock price. It is the investor's job to know the value of every company within their circle of competence and to understand a fair purchase price for each business.

To figure out a fair purchase price, let's look at a Marshmallow Company that produces the world's best marshmallows. The job of the intelligent investor is twofold—to evaluate Marshmallow Company's capabilities for producing top-rated marshmallows at a certain profit, and to reasonably predict how many pounds of marshmallows the company will produce today, as well as many years out. Very few businesses on the planet, of course, fit the description of a rising, profitable marshmallow producer—so when an investor identifies this unique business, it usually pays to purchase a meaningful amount. The objective to investing is to correctly figure out today's value of the cash produced over the life of the marshmallow business —and then acquire the Marshmallow Company at a discounted price. Generally, an intelligent investor tries to pick up $1 of today's value at a price that is much less than $1.

How should the investor react to the changing nature of food company stock prices? Intelligent investors intently keep an eye on *marshmallow pounds sold at a certain profit*. To the intelligent investor, investment risk resides not in short-term fluctuations in the quotation price of food company stocks (including Marshmallow Company) or in the number of food companies one puts money into, but rather in a lack of clarity about Marshmallow Company's ability to produce marshmallows far into the future at a certain profit. The more cloudy, the greater the hazard.

Obtaining clarity about Marshmallow Company's current and future output depends on the ability to ascertain the strength of what we refer to as the business *"ables"* including:

- **A defend*able*** marshmallow business that is difficult for competitors to penetrate
- **A sustain*able*** marshmallow business that can be viewed many years out
- **A predict*able*** marshmallow business that has a healthy (preferably growing) market share of consistently needed marshmallow products that are consumed daily—leading to steady returns on capital and profitability
- **An afford*able*** marshmallow business that is selling at a desirable price that provides an investor a fair return over time

Unfortunately, investing in such "able" businesses does not provide an opportunity to obtain riches quickly. This explains why these opportunities are not in vogue today and, in fact, are largely avoided by individuals seeking higher returns. Nonetheless, holding these valu*able* businesses over time can be financially rewarding and extremely tax-efficient (an issue we will address later in this letter).

Although simple in concept, the measurement of intrinsic business value is difficult in practice. Any given group of professionals tasked with individually evaluating the details of Marshmallow Company will invariably reach different conclusions about its business value based on several factors, including future profits, capital requirements, interest rates, and projected growth rates. Regardless, a fair business valuation for Marshmallow Company (or any business) requires not only the facts determined through financial analysis but, more important, the wise lens of business analysis.

Lesson of Intelligence and Wisdom

> **"Wisdom is the laughter of experience."**
> ***—Leonardo DaVinci***

Warren Buffett often gives business students throughout the world an opportunity to ask him questions on business and investing. A business student in India once asked him, "What makes Warren Buffett a great investor? Is it the intelligence or the discipline?" Warren's response, "The good news I can tell you is that to be a great investor you don't have to have a terrific IQ. If you've got a 160 IQ, sell 30 points to somebody else because you won't need it in investing. What you do need is the right temperament. You need to be able to detach yourself from the views of others or the opinions of others." In an answer to a similar question, Warren stated, "Your habits, character, temperament, and ability to think independently together allow you to behave rationally." If the rule of successful investing involves having some intelligence (an IQ of 130 is still high), what are the habits, character, temperament, and ability to think independently that allow one to behave rationally?

A Word on Intelligence

According to a 2012 study from researchers at the University of Western Ontario, the traditional methods of IQ testing to measure intelligence can be misleading. Dr. Adrian Owen, the Canada Excellence Research Chair in Cognitive Neuroscience and Imaging at the university's Brain and Mind Institute, was an investigator on a study that included 12 separate cognitive tests involving 100,000 study participants. The study found that there was no such thing as a single measure of IQ or measure of general intelligence. What the study did find through its extensive testing and brain scan monitoring is that there are three discrete networks within the human brain that constitute our intellectual abilities—verbal, reasoning, and short-term memory—and these reside in different parts of the brain.

So, let's attempt to apply intelligence to the investing process. If intelligence is based on the ability to learn and communicate, use memory to recall, and apply the skilled use of reason, why is it that even the smartest investors have difficulty? Let's assume that most professional and nonprofessional investors possess the intellectual qualities needed for successful investing. We ask ourselves a different question when assessing investment intelligence: What is the difference between being learned and intelligent, as opposed to continuously learning and seeking intelligence? To us, intelligence is not a trait, but a constant pursuit.

In our experience, while most individuals participating in the investment markets have high intellect, very few have the discipline to "farm," i.e.: Consistently study different companies in various industries (till the soil); invest capital in a selection of businesses they fully understand (plant seeds); acknowledge and remove mistakes when they occur (weed non- and substandard performers from the portfolio); and constantly add capital to great businesses when the price is right (water the plants). In addition to lacking the discipline required to cultivate wealth, most investors lack the patience required to harvest wealth, an important part of the investing process that needs to be done in a tax-efficient manner. Most investment professionals and nonprofessionals tend to trade too often—lurching from one investment to another driven by the belief that "greater returns are achieved through greater churns." Warren Buffett refers to investment temperament and an ability to think independently from the crowd as important ingredients to successful investing. We refer to this as gaining and applying investment wisdom.

A Word on Wisdom

At Founders, we strive to achieve the right investment temperament to drive our success in allocating capital. We think independently as we work interdependently within the firm to ensure that we are disciplined in our constant study of businesses across various industries. We endeavor to identify the prices we are willing to pay for specific businesses and to remain disciplined in waiting for the right opportunities (prices) to come along. We also seek investment wisdom, which can only be developed through experience and continuously refined through effective questions. Following is a sampling of questions we contemplate when investing capital:

- **What is the difference between being humble and applying humility?**
  Being humble(d) is usually a cathartic exercise that occurs upon realizing one's mistakes. On the other hand, we have learned to approach each investment with humility, remaining open to any facts and experience that may prove an originally positive investment thesis to be negative. Striving for humility is a habit that assists us in managing and regulating our emotions, both positive and negative.
- **What is the concept of accepting our circumstances, as opposed to having acceptance?**
  Accepting difficult investment circumstances—whether the falling prices of all stocks across the board, or of individual positions we own—is also an important aspect of investing. On our view, having acceptance extends to include accepting that things may or may not change in the future. Having acceptance is an ability to look in the mirror and accept things for what they are, admit mistakes, move on and realize that other opportunities will surface. This habit keeps us honest with ourselves when investing capital.

- **What is the difference between being able to move past obstacles and having resilience?**
  Moving past difficult obstacles in the investment business is important for success. Examples of difficult investment obstacles include understanding a technical industry, such as the complex realm of biotechnology; or misreading a disruption occurring in an industry and its impact on a company we own. Having resilience is the habit of adaptability—the ability to reconceptualize difficult investment situations. We strive to habitually think multidimensionally by expanding assumed boundaries when studying a new or old industry.

- **What is the difference between evaluating another viewpoint and having perspective?**
  Good investors evaluate another viewpoint when investing; great investors develop perspective by studying as many viewpoints as can be gathered. When reviewing an investment—whether one we already own or one we would like to own—we seek as many viewpoints as we can find to enable us to look at the investment from all conceivable angles. We strive to develop the habit of perspective to gain a rational view of our investment activity.

- **What is the difference between being passionate and compassionate?**
  Passion is an all-important ingredient for successful investing. A good investor needs to be passionate and curious about the subject matter, enjoying the full process of investing—including reading thousands of annual reports over time. Great professional investors are compassionate about investing—so much so that they invest their personal money alongside that of their clients. They also develop a deep understanding of industries and businesses and how they are interconnected. The habit of compassion takes passion to a higher level, as the only way to differentiate oneself in the investment business is through greater empathy with clients and a deeper understanding of the businesses within one's circle of competence.

Ultimately, the character traits that constitute investment wisdom better position an investor for success than does a higher intellect, and successful investors must pursue continuous cultivation of these character traits.

Lessons of Taxes, Investing, and the "Unmanaged" Index Fund

Let's start at the end. The primary goal of every investor should be, while strictly limiting risk, to achieve the highest *after-tax* total return available over the longest possible duration. In reality, this means doing two things: Achieving the highest *pre-tax* total return one can find, while minimizing the tax "drag" on those returns—without compromising them.

While this point may sound a bit obvious, it is a foundational idea of investment practice. We often find that investors lose sight of the primary goal of investing—to achieve the best possible after-tax results—instead getting caught up trying to avoid taxes entirely instead. Of course, avoiding taxes is easy: Don't generate any gains on your investments—a simple savings account will do. But, of course, using this approach, don't expect to see any satisfying after-tax total returns.

The government tax system on capital assets in non-retirement accounts (such as stocks and bonds) is set up in a helpful way: As an asset grows in value, the government automatically "cuts itself in" on the gains to the tune of 15%–20% at the federal level and another (usually single-digit) percentage at the state level. In total, investors typically end up "sharing" 20%–30% of their gains with the government.

But that sharing has a couple of unusual features: First, you only have to cut the government in upon the *sale* of the stock or bond. Any unrealized appreciation in the asset is yours to keep—for now. Moreover, if that security is passed along at your death, its cost basis is "stepped up" to its price at that time—and capital gains tax on any appreciation that occurred during your lifetime is wiped out. Both provisions encourage investors to buy for keeps, as they should. And both provisions substantially influence the way we invest. To see why, let's do a quick bit of math.

Take two investors: Investor H and Investor T. Investor H buys an asset that appreciates at a rate of 12% compounded for 20 years, and then sells at the end, paying a 30% tax on sale. Investor H now has $7.05 for every $1 invested—an after-tax rate of compound of 10.3% per year.

Investor T buys a series of investments earning 12% per year but sells and replaces them at the end of each year. How much does Investor T end up with after the same 20 years? Only $5 for every $1 invested, for a compounded rate of return of 8.4% per year.

The difference between the two—a shocking 1.9% per year—is *entirely* due to Investor H's long-term deferral of taxes. Deferring capital gains by buying long-duration assets is a high-impact, low-risk way for investors to improve their after-tax total return—and at Founders, we do everything in our power to maximize this.

Every model, however great, still has its limits. If not managed carefully, an *over*-attachment to tax avoidance can cost as much as it pays. To understand this point, we need to consider a second core investment concept: Achieving investment nirvana sometimes requires a conscious decision to "change horses" over time.

Between 1970 and 2019, the S&P 500 returned more than 10% per year, compounded, to anyone smart enough to hold on. The returns of the index came from two primary sources: Earnings growth of the underlying companies and growing dividend distributions. The "earnings growth" component provided about 7% per year, while the dividend component averaged about 3%. A fortunate investor who had purchased the S&P 500 and held on to it for the full 50 years, reinvesting his dividends, would have ended up with roughly $145 for every $1 invested before accounting for taxes.

With results like that, most individuals in the business of buying equity investments logically hold this index result as their long-term "hurdle". If one can achieve satisfying results with a simple "unmanaged" index, why settle for less elsewhere?

But the secret to success in the index lies in a simple fact: It isn't "unmanaged" at all. Between 1957 and 2003, there were 917 additions to the S&P 500, an average of about 20 per year—meaning, of course, that hundreds of companies were removed from the index as the years went by. The turnover hasn't been modest. Standard & Poor's showed in 2007 that only 86 of the original 500 companies remained in the index. Since that time, at least 20 more have been removed. An investor who had purchased the original S&P 500 constituents in their original weighting individually and held on to them over the decades with no adjustments would have earned poorer returns than that of the index itself, as a large number of those companies went on to fail or otherwise perform poorly.

The genius of the process is in its reflection of the competitive, dynamic capitalist process: The index buys into companies as they become increasingly great, lets the best performers run, and reallocates money away from companies that have become much less great or—through mergers, acquisitions, and competitive destruction—have ceased to exist. Accordingly, the index's returns are driven by the success of a select few corporations that grow tall over time.

The original designers of the index could not have foreseen the success of companies like Apple, Microsoft, Wal-Mart, Amazon, Google, and others that didn't exist at its creation. But through a structure that allowed those current market titans to replace once-barnburner companies like International Shoe, American Chain & Cable, and Associated Dry Goods while holding on to winners like Coca-Cola and PepsiCo as their value continued to increase, the index turned in an incredible 50-year performance.

As goes the broadly diversified index, so too must go our own focused portfolios. **At Founders, we seek to let an organic process of change play out over long periods, such that our portfolios continue to reflect the best opportunities we can identify**. **We seek to allocate capital into great opportunities and away from those we feel are becoming much less great, while maximizing the overall tax efficiency of the portfolio as best we can manage.**

To achieve the best possible after-tax total return for our portfolios, we must artfully balance the competing demands of tax efficiency and capitalism dynamics. Allocating money away from a dwindling opportunity and into a promising one often requires cutting in the tax man when gains are realized. But ignoring either the dynamics of capitalism or the importance of tax efficiency would lead to worse results—and that is just what many investors do (or ask their advisors to do). Those seeking to make money as rapidly as possible "change horses" repeatedly and incur a tax drag that seriously impairs their results; conversely, those hoping to avoid the tax man at all costs tend to hold on to securities long after they have ceased offering great opportunities for wealth creation. Only by appreciating the strengths and weaknesses of both models can an investor hope to turn in the best possible after-tax results over time.

Lesson of Investment and Speculation

We have all experienced the feeling of being influenced to go along with the crowd even when we may be privately questioning our decision. Human tendency is to band together, surrendering to our insecurities based on a number of factors:

Fear

Fear of being the "outsider" from the collective opinion that must deal with continual reminders of adverse opinions. It is much easier to vocalize an argument when there are numbers of people supporting your view; far more difficult when taking the opposing view and having to remain steadfast over time until the truth is revealed. Acquiescing to the group mentality is ingrained in our DNA and is an evolutionary trait that, in many cases, has helped to propel humanity to its position at the top of the food chain. But resisting the instinctual urge to follow the crowd can have major benefits in certain arenas—for example, in the stock market.

The stock market is very susceptible to swift movements in response to analyst reports and industry announcements. The volatility in stock prices may be good for day traders or for program traders who use algorithmic software, trade in large quantities, and have direct market access (compared to individuals that trade via middlemen). Direct market access enables program traders to make fractions of a cent on the execution spread between sale / buy prices. Scaled by millions of shares, program traders piece together wealth in their accounts through a plethora of daily transactions. How does one who does not subscribe to this hoopla, and whose tools are not as intricately connected to the market, stand a chance? The simple answer is to treat the market the way it was intended, through investing. Investing is the process of recognizing value through extensive research, forming an investment hypothesis based on strategic factors and, finally, ensuring that the quantitative metrics are aligned with the hypothesis. Investing requires a mentality of ownership—that you have taken up a contract to become tied financially to a business. Approaching investment in a company from the standpoint of an owner brings key considerations into focus: The company's growth consistency, management's emphasis on sound financial decisions, a strong balance sheet, and effective use of capital. Such an investor is not looking to make a quick buck, as he is in it for the long haul.

This long-haul conviction, based on extensive research and independent thinking, provides the confidence needed to "go against the grain." It is important to stick to one's own informed opinion when facing adverse viewpoints generated by the excitement of a crowd.

Anchoring Bias

Hearing about a revolutionary new technology or reading an article touting the explosion of money to be made by investing in a specific business can subject a person to an anchoring bias—the tendency to rely too heavily on an initial piece of information about a subject. For example, an analyst report upgrading a specific company can cause an immediate, chaotic momentum swing on a stock price based on positive investor sentiment. Or a "stock tip" from an industry professional about an up-and-coming company with a "growth-driven business model" may convince an investor to act fast to take advantage of this "special opportunity." These situations prey on our inherent anchoring bias as well as "FOMO" (Fear of Missing Out): No one wants to be the person who didn't buy into the pool of lottery tickets that strikes the jackpot.

Over the past few years, the market equivalent of a lottery ticket has been technology IPOs. The masses have flocked to the initial offerings of these technology companies with hopes of unlimited stock highs and achieving exponential gains. Yet these IPOs have shown a very consistent downward trend:

Snap Inc. debuted on the New York Stock Exchange on March 1, 2017. The shares were issued at $17 and, within two days, had jumped 73%, to $29.44. Pretty good return, right? Well, Snap Inc. has never traded at this price since. In less than three months, Snap was trading back at its $17 debut and several years later, at year-end 2019, was trading well below, at $15. This highlights the initial infatuation with this offering, with everyone jumping on the bandwagon, not wanting to be the only one left off the money-making machine. Almost immediately, after initial speculators who had made their quick money got out, emotions began to settle, and the stock price began to reflect the true value of this entity. A few more examples will highlight that this situation is not an anomaly; three major technology IPOs that debuted in 2019—Lyft, Pinterest, and Uber—sang a similar tune:

- **March 28, 2019:** Lyft (NASDAQ: LYFT) shares were offered at $72, which quickly climbed to $88.60 for a 23% gain. At year-end, the stock was trading at $43.02—a loss of more than 51% from the IPO high.
- **April 17, 2019:** Pinterest's (NYSE: PINS) debut started at $19 and climbed to a high of $35, gaining 84%. Currently trading back at its debut price of $18.64, Pinterest has lost all its "perceived" value in just over 8 months.
- **May 9, 2019:** Uber (NYSE: UBER) offered IPO shares at $45. But in this IPO, the market seemed to have learned from the recent Lyft precedent—Uber's shares collapsed at first, to $36, losing 20%. Uber shares rallied back to the $45 offering but at year-end were trading at $29.74. A buyer at the time of the $45 IPO would have amassed a loss of approximately 34%.

The lesson here is to not make speculative investments—i.e., do not buy stock based on anticipated higher price movements, instead of on the fundamental value of the company. Successful investment speculation looks easy in hindsight, and our own optimism bias convinces us that we will not be the ones to lose money. An investor should remain disciplined and resolute in her knowledge of an asset's real value, even when the price of speculative assets continues to rise, given that a company's stock price eventually settles at its intrinsic value.

Comparison

People naturally tend to compare their status and situations with those of others. We see this starkly with the influence of social media. Many articles have pointed out a direct link between social media involvement and increased depression. Professional "influencers" on social media broadcast their lives depicting beautiful and lavish experiences—these are often fabrications for companies that pay these "influencers" as part of their advertising strategies.

Participants in a 1995 survey of faculty, students, and staff at the Harvard School of Public Health were asked if they would rather live in a place where they had income of $50K but the average person had an income of $25K, or one in which they had an income of $100K but the average income was $200K. 52% of the respondents preferred the $50K scenario, meaning that a majority of people would prefer to have half as much money as long as it meant that they were making twice as much as the people around them. This is a difficult truth to accept, but people evaluate their circumstances relative to others: We're only as good as how we stack up to the person next to us. Unfortunately, perception matters when money is involved—as Warren Buffett stated, "It's not greed that drives the world, but envy."

The truth is that there will always be someone getting richer at a faster pace than we are and so, as investors, we should not be swayed into following the crowd and accepting speculative behavior with money as a means to propel ourselves above whatever is perceived to be "rich."

Momentum

A speculative investment that has risen above its already stretched objective value may confirm the view that this is a good investment and spur an investor to buy more. In reality, that investor is acquiring the same asset for a higher price while crossing his fingers that past results will guarantee future outcomes. If one considers buying a home for its listing price (and appraised value) of $300,000 on Monday, and on Tuesday the asking price goes to $350,000, one wouldn't think, "I need to buy this house now, before it goes to $400K!" Purchasing the house at a higher price than its appraised value would clearly be a bad investment, but equivalent scenarios happen all the time in the stock market due to its auction-like, fast-paced, pressure-filled nature. Sticking to foundational principles with discipline and conviction allow one to take advantage of opportunities when they arise: When a good business with predictable cash flows comes along, the preparation and strategic buildup of capital allow investors to strike swiftly.

In a world full of stimuli attempting to influence us to take quick action, investors should step back and remember their core philosophies. When evaluating potential returns, we should fully understand where our money is held and be completely comfortable with the decisions being made based on a proper assessment of a business's intrinsic value.

* * *

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, we remain agnostic to any market's short-term movements, avoiding the influence of emotional reactions to these fluctuations. 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 will continue to invest with our eyes wide open and with the 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 have 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***

MANAGEMENT'S DISCUSSION & BUSINESS UNIT REVIEW

Equity Holdings: 2019 Highlights

The intrinsic value of our aggregate equity holdings increased during 2019. 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, Federal Express, Microsoft, Google, Intel, Berkshire Hathaway, Wells Fargo, American Express, CarMax, Home Depot, Walgreens, Disney, 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 2019, along with our expectations for 2020.

CONSUMER GROUP

Our primary consumer holdings—Coca-Cola and PepsiCo—continued to grow their global franchises during 2019. On a combined basis, these entities reported adjusted organic growth in global sales of 4.9% due to the continued development of their respective franchises. Aggregate reported operating profits for these combined entities increased approximately 2.5% in 2019, however, due to a negative foreign exchange impact. 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 continue to cultivate their presence in both developed and emerging global markets.

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

1. An estimated 64 billion servings of non-water beverages are served each and every day around the globe. Coca-Cola and PepsiCo supply approximately 2.8 billion (4.37%) 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 130 annual servings per person on earth, there remains a lot more market share to grab. 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 225 bottling partners use more than 500,000 vehicles to distribute 4,300 beverage products through 28 million retail 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 make them available 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 2019, 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 among the top 525 reported shareholders of this great company.

During 2019, The Coca-Cola Company's overall case volume growth grew at approximately 2%. Over the past six 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. Nevertheless, 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. Coca-Cola's net operating revenue increased around 8% to approximately $37 billion in 2019 (including acquisitions and dispositions), while organic revenue and neutral operating profit have grown around 5% year-over-year in 2019.

For the past six years, Coke had been experiencing revenue declines in reported sales, and this trend turned the corner in 2019. As background: 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 moved 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 were demanding. By consolidating bottling and distribution for all Coca-Cola products in North America, Coke gained control over its production and delivery systems, with the flexibility required to respond to a changing beverage marketplace. The downside to consolidating bottling and distribution was the temporary increased capital intensity of Coca-Cola's beverage business, which 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, and the required changes to the bottling and distribution business have been completed to respond to consumers' diverse and changing tastes. Coca-Cola restructured its business model and sold back the controlled North American bottling and distribution system to bottling partners through refranchising arrangements. This "reverse move" lowered revenues through deconsolidation but increased the company's financial flexibility by reducing capital intensity. As of the end 2019, Coke has completed the refranchising of its territories, and over the past year, Coca-Cola resumed its revenue growth.

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®.

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.

The Coca-Cola Company will produce approximately $7.8 billion of adjusted cash for shareholders in 2019, and we anticipate that this will increase to $8.2 billion in 2020. Coke currently pays an annual dividend of $1.60 per share, which represents an approximately 2.9% yield, and we believe that the company will increase its dividend approximately 2.5% in 2020—to around $1.64 per share. Coca-Cola will likely continue 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 approximate 3.5% pass-through yield and owner-earnings yield of approximately 3.5% at Coke's year-end price, compared to a 1.93% yield on a 10-year U.S. Treasury bond. In 2020, we expect Coke to earn around $2.25 per share, representing an approximate 7% increase from 2019.

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 slightly more than 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 54% 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 specified 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 these differences to widen, and we look for PepsiCo to build on its snack-food stronghold.

Given the continued global challenges that consumer goods businesses faced this year, PepsiCo's organic revenue growth was slightly above 4.5% in 2019 (this increase excludes the impacts of foreign exchange translation and acquisitions as well as structural and other changes). PepsiCo's year-over-year net income decreased approximately 1.5%, largely due to currency exchange headwinds and other adjustments. PepsiCo continued to increase its return to shareholders, however, raising the annual dividend 3% in 2019, from $3.71 per share to $3.82 per share. We expect PepsiCo to raise its dividend in 2020 to approximately $3.93 per share, which implies an approximate forward dividend yield of 2.9% at the year-end stock price. In addition, we anticipate that the company will repurchase $2.5 billion of stock during the next 12 months. This action adds another 1.3% return to shareholders, reflecting a 4.2% forward pass-through yield. In 2020, we expect PepsiCo to earn around $6.00 per share, representing an approximate 8.5% increase from 2019.

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 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 political support for U.S. 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 investment 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.

United Technologies

United Technologies Corporation (UTC) produces Otis elevators, Carrier air conditioners, and Pratt & Whitney jet engines, among others. Each 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 generates a large portion of the company's $76.5 billion in revenue, and 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).

As we reported last year, UTC acquired aircraft parts maker Rockwell Collins in a $30 billion transaction. This was the largest aerospace deal in history and provided UTC with an opportunity to evaluate its conglomerate structure. Subsequently, Raytheon approached UTC with a proposed merger of UTC's aerospace business with Raytheon and, in June 2019, the two companies reached an agreement to merge into a combined aerospace and defense company with sales expected to approach $74 billion in 2020.

With four large, complex businesses that were in different market segments, UTC's conglomerate structure has become an anchor around each individual business—Collins Aerospace (and Pratt & Whitney), Otis elevators, and Carrier air conditioners. Thus, UTC's board decided to break up its conglomerate structure and divide the company into three discrete businesses during 2020: Collins Aerospace (and Pratt & Whitney) will be combined with Raytheon to form Raytheon Technologies Company, and Carrier and Otis will be spun off from the parent company. We are in full support of this strategy that will enable each business to focus 100% on its respective market. Ultimately, we believe this conglomerate breakup will unleash value potential based on the individual companies' newfound flexibility to flourish and compete within their respective industries. While waiting for the breakup to occur during the first half of 2020, our intention is to hold on to all three separate companies until the time that we can fully evaluate their individual prospects.

In the meantime, during 2019, UTC earned $6.8 billion of net income, or an adjusted $8.15 per share—an 8.8% increase from 2018. We expect combined per-share earnings to grow an additional 7.5% in 2020, to $8.75. When comparing the forward owner's cash stream of $7.90 per share to the company's year-end stock price of $149.76 per share, investors are receiving an entry owner-earnings yield of 5.27% on their UTC investment—and we expect the per-share cash stream to grow over the next decade, especially with the company's break-up plan that should unleash future value for shareholders. We remain very enthusiastic owners of UTC and believe we are receiving a very good return on our ongoing investment in this company.

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 2019, CSX generated approximately $12.04 billion in revenue—1.7% less than in 2018. Despite the temporary revenue decrease due to a manufacturing slowdown, in 2019, CSX increased its net profit by $150 million, to $3.35 billion, due to operating efficiency gains. Thus, CSX's adjusted operating income and net profit rose by an additional 13% in 2019. CSX's ongoing profit increases this past year requires some explanation. In 2017, the company began transitioning its operating model to "precision-scheduled railroading," which is focused on developing and strictly maintaining a scheduled service plan that emphasizes 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 2019:

- CSX's unit volume decreased approximately 3% in 2019. Revenue decreased only approximately 1.7%, however, due to higher yields on goods carried. Adding gains in railroad efficiencies allowed CSX's net profits to rise around 4.7%. Metals and equipment volume as well as fertilizer volume decreased by 3%– 5% in 2019. Coal volume also decreased by 1% this past year – following two years of volume increases. Looking into the near future, we expect that a rebound in manufacturing during 2020 will lead to increased demand for metals and equipment. We also expect demand for 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 slowed worldwide during 2019 due to trade pressures, CSX's intermodal business experienced a volume decline of 8%; this negative result this past year follows steady year-

over-year increases the previous two years. Intermodal represents a large part of CSX's business, accounting for approximately 42.5% of volume and 15% of revenue in 2019. This is down from 45% of volume and 20.5% of revenue in 2018. We can see that intermodal is a key part of CSX's business activity and expect that the intermodal line of CSX's business will rebound in 2020 as trade skirmishes subside and the global economy advances.

During 2019, CSX passed approximately $4.4 billion of cash over to shareholders in the form of dividends (around $760 million) and share repurchases (another $3.65 billion). In 2020, we anticipate that CSX per-share earnings will grow by 6% as the U.S. economy grows and the railroad continues to execute on precision-scheduled railroading. We expect CSX to distribute an additional $4.0 billion to shareholders through a combined dividend and stock repurchase program. This provides shareholders an approximate 7% forward pass-through yield at CSX's year-end price, and we believe that this yield will continue to 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 five 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 on 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 long-term 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.

FedEx Corp.

During the past 16 months, we have accumulated a position in FedEx Corp. We happened to begin buying FedEx just prior to the trade impasse with China, and this proved to be a mistimed placement of capital—FedEx's stock price went precipitously south after our initial purchase and has remained down as trade skirmishes continue between the U.S. and China. Nevertheless, we are positive on our long-term investment in FedEx and believe we will do well over time on this allocation of capital.

Background: FedEx provides a broad portfolio of transportation, e-commerce, and business services through its collective business segments that operate under the respected FedEx brand:

- FedEx Express, the world's largest express transportation company, offering time-definite delivery to more than 220 countries and territories, connecting markets that represent more than 99% of the world's gross domestic product.
- FedEx Ground, a leading North American provider of small-package ground delivery services. FedEx Ground provides low-cost, day-certain service to any business address in the U.S. and Canada, as well as residential delivery to 100% of U.S. residences through its FedEx Home Delivery service.
- FedEx Freight, a leading North American provider of less-than-truckload ("LTL") freight services across all lengths of haul, offering FedEx Freight Priority, when speed is critical to meet a customer's supply chain needs; and FedEx Freight Economy when a customer can trade time for cost savings. FedEx Freight also offers freight delivery service to most points in Puerto Rico and the U.S. Virgin Islands.
- FedEx Services provides sales, marketing, information technology, communications, customer service, technical support, billing and collection services, and certain back-office functions that support our transportation segments. The FedEx Services segment includes FedEx Office and Print Services, Inc. ("FedEx Office"), which provides document and business services as well as retail access to our package transportation businesses.

Each FedEx company focuses exclusively on the market sectors in which it has the most expertise and tailors its operations, cost structure, and culture to serve that market segment's unique customer demands. This allows FedEx to adapt its networks in response to changing transportation needs, including:

- Growth of e-commerce: E-commerce continues to be a catalyst for FedEx and is a vital growth engine for all business segments as the internet is increasingly being used to purchase goods and services. While FedEx residential e-commerce revenues are much smaller than business-to-business revenues, it is the fastest-growing market and requires innovation to make delivery to consumers more flexible, convenient, efficient, and cost-effective. As global transportation and technology networks continue to develop, FedEx will greatly benefit from the growth of e-commerce.
- Globalization of trade: As the world's economy becomes more fully integrated, companies are sourcing and selling globally. With customers in more than 220 countries and territories, FedEx facilitates the supply chain through its global reach, delivery services, and information capabilities. Despite the recent trade tensions, globalization will drive international volume growth over the long term.
- Supply chains and logistics: Companies of all sizes continue to depend on the delivery of just-in-time inventory to help them compete. FedEx integrates its business segments with customer supply chains and provides real-time information to manage inventory-in-motion, which reduces overhead and obsolescence and speeds time-to-market.
- High-tech businesses and high-value-added goods: High-tech and high-value-added goods have increased as a percentage of real economic output, and FedEx's various operating businesses offer a unique menu of services to fit virtually all shipping needs of high-tech and high-value-added industries.

These trends provide FedEx an opportunity for long-term expansion and unprecedented integration of customer goods, services, and information. Through a complex global transportation, information technology, and retail network, FedEx is positioned to connect customers and consumers throughout the world. We believe that it would be extremely difficult, costly, and time-consuming to replicate the FedEx global network, which includes the world's largest all-cargo air fleet and connects more than 99% of the world's gross domestic product.

Federal Express is expected to earn $3.2 billion of net income in its fiscal year ending May, 2020, or an adjusted $11 per share—a 29% year-over-year decline from May, 2019. We expect combined per-share earnings to recover and increase 13.5% in fiscal 2021, to approximately $12.50 per share. When comparing forward earnings to the company's year-end stock price of $151.21 per share, investors are receiving an entry earnings yield of 7.25% on their FedEx investment—and we expect per-share earnings to grow over the next decade, especially given the company's strategy to take advantage of the growing interconnected global economy. We remain positive owners of FedEx and believe that we will receive a very good return on our ongoing investment in this company.

TECHNOLOGY GROUP

Each year, we begin this section by highlighting the investment opportunity potential of the information technology sector, 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 2019, the technology sector once again experienced change at breakneck speed as device miniaturization continued, cloud computing flourished, and software enhancements enabled the advancement of artificial intelligence (AI) 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 12 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 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. Technology 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.

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, seven 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 viability 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 72 months, Mr. Nadella led Microsoft back to the forefront of technology change. The organization had turned on a dime, successfully shifted its primary focus away from Windows and devices, and has emerged as a leader in 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, Adobe, IBM, and Rackspace. Obviously, cloud computing offers businesses an opportunity to reorganize their IT infrastructures and decrease their reliance on corporate servers—resulting in overall savings in their IT spending budgets.

This area of the technology industry is “sticky” because corporate customers are not as fickle as retail consumers who change products in 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 jumped from 10% in 2017 to approximately 17% in 2019—and Microsoft recently won the Pentagon's $10 billion JEDI cloud computing contract over Amazon, grabbing more market share. Although Amazon Web Services (AWS) has maintained a leading 33% share of the cloud infrastructure market this past year, the cloud computing business is still 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 2019, and we are enthusiastic about the company's prospects in 2020. Microsoft's adjusted earnings are expected to be $5.40 per share in its fiscal year-end June, 2020, putting the company on pace to reach per-share earnings exceeding $6.00 by its fiscal year-end 2021. During this fiscal year, Microsoft will generate approximately $40 billion of owner earnings and will return a large amount of this cash to shareholders through net share repurchases of approximately $20 billion and around $15 billion of dividends (an approximate 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) and have continued to add to this position in 2019. This allocation was originally a transition from our emphasis on IBM. We will continue to 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 (AI). With the rise in cloud computing, massive amounts of information is being housed on interconnected computers around the world, and companies are seeking to turn this information into useful knowledge through the implementation of 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, "serverless computing" has become an innovative way of writing software. It is a form of utility computing whereby the cloud supplier owns the servers, and pricing is based on the actual amount of resources consumed by an application on the backend, 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 independent of the developers subscribing to the service. "Serverless computing" is also combined with "open source" software, which is software that is released through a specific kind of license that makes its source code legally available to be studied, modified, and redistributed by the software-writing community. Ultimately, the cloud has made for unprecedented efficiency and data-sharing within the software development community. The standardization of the cloud across all major players, however, has weakened a programmer's brand loyalty to any one cloud provider. The tradeoff is the unlimited amount of data being shared and the flourishing of innovative, openly shared software development.

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 systematically learn and can even teach, to an extent. Today's digital intelligence is based on massive data-gathering and analysis, and increasingly sophisticated AI is becoming more prevalent.

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 AI 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. Google remains Alphabet's largest subsidiary. Google focuses on Internet-related products and services that include internet search, online advertising technologies, cloud computing, and software and hardware development. Google's market share of global online searches exceeds 90% (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 (85% market share), the Google Chrome web browser (70% market share), and Chrome OS, a lightweight operating system based on the Chrome browser that has a 60% market share among all laptops and tablets in U.S. K-12 classrooms.

So why does Alphabet have a tremendous opportunity in the AI space? The pervasive use of Google's search engine enables Alphabet to gather, manipulate, and understand our individual and collective behaviors in a multitude of beneficial ways. The massive amount of compiled data gives the company an edge in developing AI. Google itself is a learning machine that adapts each day based on the intelligence it gathers. Businesses using Google Cloud have access to immediate software solutions, increased efficiency through data management, and improved operational excellence via AI influence. The information gathered through both individual data (search, health, maps, etc.) and through business operations through Google Cloud allows Alphabet to develop related offshoot businesses as the company scales its learning capabilities. The information gathered acts as a catalyst to propel these to compete in emerging markets, such as self-driving vehicles (Waymo), data science and healthcare (Verily), the application of AI (DeepMind) and home security and connectivity (Nest). These additional "bets" are all strategically integrated around Alphabet's most valuable asset—the information gathered through its products and services. The information allows Google to adapt instantly to emerging consumer trends and deliver the most user-friendly, consumer-driven software on the market. Google's pervasive network of interconnectivity also creates consumer reliance on integrated Google software and hardware that will continue to grow as the company integrates additional products and services in the future.

Alphabet is an extremely profitable company that produced adjusted earnings of $37.5 billion in 2019, or $53.10 per share. In 2020, Alphabet is expected to grow its per-share earnings to $60.25 and produce owner earnings of approximately $35 billion. This will add to Alphabet's $120+ billion cash hoard on its balance sheet, with minimal debt. With Alphabet's total market capitalization of $923 billion and removing cash of approximately $121 billion, a buyer of Google is obtaining a 4.35% owner-earnings yield that is growing at approximately 12% to 15% per year. At the current price, Alphabet continues to provide us an opportunity to own a great collection of promising enterprises that have high growth potential through expanding service interconnectivity.

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 4,526 co-located datacenters in 123 countries (around 40% located in the U.S.) make up the "global computing platform." These datacenters collectively contain more than 75 million interconnected 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 that Intel will play an important role in evolving computing technologies 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 was essentially flat for 2019 versus 2018, at approximately $71 billion. Profits increased slightly, however, to $20.5 billion, as the company experienced broad-based strength in the PC and data center markets. As a result, Intel will earn approximately $4.61 of earnings per share in 2019, representing a 6.4% year-over-year increase. We expect the company to continue its growth in future years as it further penetrates the data center sector and works to develop a profitable foothold in new business segments like the Internet of Things. In 2020, we expect Intel to generate approximately $17 billion of owner earnings and return approximately $16.5 billion of cash to shareholders through dividends of $5.5 billion and share repurchases of approximately $11 billion, respectively—Intel's dividend yield is approximately 2.1% at the year-end stock price, and the forward pass-through yield is approximately 6.5% 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

As in past years, Berkshire continues to be among our largest holdings. Growth in book value per share—the most useful year-to-year proxy of Berkshire's change in value—will likely have ended 2019 above 15%, a remarkable result given Berkshire's large size, but aided by a strong stock market.

Berkshire has now spent 55 years accumulating world-class businesses under one large umbrella. Berkshire probably has the largest and most impressive property-casualty insurer and privately owned utility operation in the entire world, as well as one of the largest and best railroads in the world. Supplementing this is a large industrial products, consumer products, and services operation with units involved in specialty chemicals, specialty metal products, fast food/candy, carpets, tank cars, manufactured houses, real estate brokerage, and airplane parts, among many other things, each of them world leaders or among the world leaders. Again, we find the whole operation remarkable in its scope and quality.

In addition to this large and growing collection of businesses: Inside its insurance operation, Berkshire has one of the largest actively managed stock portfolios in the world. Berkshire's stock investments have been widely discussed, but one remarkable fact that goes relatively unnoticed is how concentrated Berkshire continues to be in its largest investment ideas. Adding it up, Berkshire's five largest positions—Apple, Bank of America, Wells Fargo, Coca-Cola, and American Express—represent roughly 2/3 of its entire $230 billion (or so) equity portfolio, representing a similar share of focus to when Berkshire was less than 1% of its current size. Apple stock alone approaches 30% of Berkshire's total current equity portfolio.

We think Berkshire's is by far the most unusually managed portfolio of its size in the world; any other large asset manager we can think of would have split that $230 billion among hundreds of positions. This continuous focus on his best and most impactful ideas is a testament to Mr. Buffett's extraordinary discipline, which has served Berkshire shareholders well over the years. The recent investment in Apple shares alone has netted Berkshire more than $40 billion in pre-tax profit.

Great as it is, Berkshire must deal with two issues at its current size and state—both of which we watch closely, and neither of which has any chance of seriously imperiling the company as far as we can determine.

The first issue is Berkshire's large and growing pile of cash, which hampers its ability to grow (on a percentage basis) at more than a modest pace. One of the primary results of Berkshire's great success is a prodigious, growing pile of cash flow that must be reallocated, given Berkshire's unwillingness so far to pay dividends. There are four primary ways for Berkshire to reallocate its excess cash internally: Investing in securities, buying large business operations, buying small bolt-on acquisitions, and buying back its own shares. In 2019, Berkshire chose primarily to repurchase shares and invest in the stock market in modest quantities but announced no major acquisitions. Thus, Berkshire ends the year with more than $130 billion in cash, equivalent to more than $50 per B share—or more than 20% of the value of the entire company. Because Berkshire is so cash-generative, next year is likely to bring another $25 billion or more to the pile. What Mr. Buffett chooses to do with all this cash will have a major impact on Berkshire's future.

In the end, we consider this a "nice problem to have," but reflective of the state of both Berkshire as a company and the markets as a whole. There simply isn't much Berkshire scale opportunity at the moment. Berkshire's size means that its shareholders must adjust to a reality of more modest annual growth rates over the long term, even if depressed markets give Berkshire more opportunity.

The second issue Berkshire must contend with is the aging of Mr. Buffett and his partner, Charlie Munger. Mr. Buffett took a major step to address this issue in 2018 by promoting Ajit Jain to the head of all insurance company activity and Greg Abel to the head of all non-insurance activity, a move we were glad to see. He also has two deputies helping to manage Berkshire's stock portfolios, although their combined responsibility is roughly 10% of Berkshire's total equity portfolio. (Though, as we mentioned previously, five positions make up the majority of the portion they do not manage—with not much oversight needed.)

This leaves the question of Buffett's personal successor as CEO of the collective enterprise. Given Berkshire's size and complexity, the next CEO must combine a great deal of intelligence and ability in capital allocation with a strong reputation as a leader and risk manager. If anyone in the world can manage this well, we believe Mr. Buffett can, but it is hard to replace someone of his caliber. We will continue to watch this issue closely.

For now, Berkshire continues to grow at a modest and predictable pace, producing large amounts of cash flow and reallocating that cash as best it can. The large businesses that Berkshire owns will be great for a very long time, and we are happy to be shareholders.

Wells Fargo

Wells Fargo is one of the oldest continually operated financial institutions in the world. Founded in 1852 by Henry Wells and William Fargo—who also founded another holding of ours, American Express—Wells was set up to provide banking services and express package delivery by horse and stagecoach, primarily in California. If these two businesses seem unrelated in modern times, this wasn't an uncommon arrangement at the time: One way to bank through the first half of the 20th century was by opening a *postal* savings account.

The 20th century was one of "organic" (internal) and "inorganic" (acquired) growth for Wells Fargo. It was consistently among the most profitable regional, and then national, banking companies, which led it to be well-positioned to acquire banks like Crocker National, Barclays of California, First Interstate, National Bank of Alaska, and others, culminating with a major merger with Norwest Bank which, at the time, was a very large operation based in Minneapolis but with branches all over the Midwest, Mountain West, and South. (Norwest was actually the larger bank, but Wells had the better brand, so its name was kept in the merger.)

Perhaps the most meaningful chapter of Wells' history was its performance during the 2008-09 financial crisis. Then as now, Wells was among the largest mortgage operations in the country. Yet, unlike most mortgage originators, Wells skipped the more egregious abuses that led to the financial crisis, including pay-option ARMs, teaser-rate subprime mortgages, CDOs, and so on. In so doing, Wells had a loan loss performance far better than its competitors and positioned itself to acquire Wachovia in October 2008—a bank that had not avoided those problems and thus was brought to its knees by the Great Recession.

By the time the financial crisis had passed, Wells was the most valuable bank in the U.S. and the envy of its peers. As it often the case, however, Wells' greatest strength became a great weakness—temporarily, at least.

Wells had long touted its ability to "cross-sell" multiple products to the same customer, creating "sticky" long-term relationships that would improve its return on capital compared to its peers by (based on the belief that it is much less expensive to provide services to an existing customer than to acquire a new one). Wells was so successful at this that other banks would regularly claim to be imitating the "Wells Fargo model" of cross-sell. At its peak, Wells had an average of more than six accounts per customer. That could mean a customer having a checking account, savings account, credit card, home equity line, brokerage relationship, and auto loan all with Wells. These productive relationships created a very low-cost, stable franchise of deposits, lending relationships, and fee generation that Wells could profitably exploit without taking on a great deal of risk.

The model started to develop problems, however. A component of Wells Fargo employees who had become accustomed to being compensated for cross-selling began opening false accounts in their customers' names to goose their cross-sell numbers. They committed other sins, such as charging inappropriate fees to customers or closing accounts that shouldn't have been closed. When it all came to light, customers were justifiably angry, and in early 2018 regulators took notice—and action—requiring Wells to sign a consent order with the Federal Reserve to apply an "asset cap" that continues to be in effect today. As a result, Wells is not allowed to grow its asset base (loans, securities, etc.) to a level exceeding its December 31, 2017 level. Wells lost its CEO as well as his successor in rapid fashion.

This begs the question: Why would we own a bank dealing with so many issues?

The truth is, for all its problems, Wells is in quite good health—as are most U.S. banks. In the aftermath of the 2008-2009 financial crisis, the U.S. banking system has been forced to become safer, less aggressive, and more reliable—and, for the most part, it has succeeded. Wells Fargo, in particular, participates in areas of the financial system that we feel most comfortable with—primarily, vanilla mortgage lending, prime auto lending, personal lending, transaction services, commercial lending, wealth management, and general business banking. With a mostly domestic footprint, Wells is far less exposed to overseas problems than its peers, and it is not among the large players in derivatives, trading, investment banking, and other areas that we find harder to understand or predict.

Despite its mistakes, Wells is still a very good bank, both financially and operationally. Like other great organizations, its successes had blinded it to mounting problems, and it failed to rein in an over-aggressive culture of its own making. As its troubles came to light, we began to believe that Wells' stock price was too harshly discounting the true long-term impact of its problems, which were both temporary and solvable.

Due to its years of success, Wells has accumulated perhaps the most important asset in banking: The trust and habitual loyalty of tens of millions of customers. And even through the period of distrust caused by its infractions, Wells has continued to maintain its ever-important deposit base.

The numbers don't lie. At the end of 2016, Wells showed deposits of around $1.3 trillion dollars. The company's most recent annual report, following the well-publicized issues, showed deposits of...about $1.3 trillion. (Remember, Wells is not allowed to grow.) Just as important, those deposits come at a very modest cost: Wells currently pays a mere 7/10 of 1% to hold that $1.3 trillion, a figure that—along with operational discipline and a large fee-based business—allows it to redeploy the money at an attractive return for shareholders without taking a great deal of risk, as higher-cost banks must do.

As it cleans up its act, Wells continues to earn excellent returns on its assets, even in light of the elevated spending to alleviate and atone for its mistakes and the relatively modest interest spread most banks operate under today. In addition, one of Wells' largest overhangs was solved in 2019: The hiring of an appropriate CEO. In October 2019, Wells elected as CEO Charlie Scharf, one of the most respected bankers in the country. Scharf is the former CEO of Visa and the Bank of New York Mellon and, before that, he was the long-time head of retail banking at J.P Morgan Chase under CEO Jamie Dimon. We were pleased with the news.

Wells continues to labor under its "asset cap" for now, but we believe the cap, that will be removed in the reasonably near future, is some ways a positive: A time of very low credit losses such as the present is often when banks build up problems that haunt them in later years. Wells has no such temptation, given the imposed restrictions on its growth. Even when the asset cap is lifted, Wells' days as a fast-growing bank will be over—with one of the three largest deposit bases in the country, Wells is simply too large to grow at spectacular rates anymore and, legally, is not allowed to acquire other deposit-taking banks.

While we like growth, this reality gives us as much comfort as it does pain: Most of the worst problems in banking come from too-rapid growth, and we feel that the modest pace at which Wells will grow in the future is probably the right one to keep it from doing unwise things.

In the meantime, Wells is returning a great deal of capital to its shareholders. Besides a generous 4.5% dividend yield against our average purchase price, which will grow over time, Wells received approval in June to repurchase $23 billion of stock over the ensuing 12-month period, equivalent to more than 10% of its then-outstanding shares. This is a total return to shareholders of almost 15% per year without any change in Wells' valuation relative to earnings or any growth in the franchise, both of which we expect.

When the time does come to grow again, Wells will be doing so on a much-reduced share count and with an asset base that appears to us to be healthy and sound. Given the price we paid for our shares, we feel there is a high probability of a satisfying result over a period of years, with a low level of risk taken to achieve it.

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. Due to its growth in price since our initial investment, American Express has become a large part of our portfolio, and it is worth reemphasizing this company's underlying business strategy.

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 (an American Express customer’s monthly spend is up to 2x greater than that of a Visa or Mastercard customer).

The American Express Competitive Advantage
In addition to its use of a single closed-loop system, American Express holds 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 encompass 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 2019, American Express produced around $6.7 billion of earnings, or $8.12 per share. The company distributed about 85% its earnings to shareholders—through dividends of $1.4 billion and share repurchases of approximately $4.3 billion—representing a pass-through yield of 5.6% at the year-end stock price. In 2020, we expect American Express to increase its earnings per share approximately 11%—to $9.00. 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—CarMax, Home Depot, and Walgreens Boots Alliance—collectively had another year of expansion in 2019, with combined retail purchases growing at 2.6% at these specialty businesses. We expect the combined sales growth of our retail group to exceed 2% in 2020. The expanding intrinsic business value of CarMax and Home Depot was reflected in their increased stock prices this past year, while Walgreens' value was not fully reflected in its stock price, which deteriorated during 2019. We currently remain owners of two of these great businesses (We discuss our recent sale of Walgreens in this section), and we are confident about the collective growth in intrinsic value of our remaining retail franchises as they continue to execute on 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 (having gone through bankruptcy) and JCPenney continue to struggle in one or more of these areas, resulting in ongoing deterioration of sales and profitability.

Our interest is in large, industry-specific retailers that gain economic value as their industries consolidate over the long term—CarMax and Home Depot continue to fit our retail holding requirements. 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 the used auto and home improvement spaces. Despite tough competition, 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.

CarMax

In late 2018 and early 2019, Founders established a meaningful position in CarMax, the largest seller of used cars in the country. Surprising to some, CarMax was created in the 1990s under the umbrella of Circuit City, the now-bankrupt electronics retailer, and spun off in 2002. Since its inception, CarMax has grown to own more than 200 used car dealerships across the country, occupying most major markets. While 200 may not sound like an overwhelming number, given that there are 18,000 franchised car dealerships and thousands of independent used car dealers in the country, a CarMax often carries upwards of 5–10 times as many cars as a nearby dealer, making it a major force in used-car selling in the U.S. In fiscal year 2019, CarMax sold roughly 3.3% of all used cars in the part of market it occupies (cars up to 10 years old).

CarMax has a relatively simple business strategy: Eliminate all the aspects of buying a used car that customers don't like. CarMax makes it easy to sell a car for a fixed, no-haggle price (they will take your car even if you don't buy one of theirs, and even if it can't put yours on their lot). Salespeople earn a flat commission for any car you take off the lot no matter what price or make/model, eliminating the pressure to upsell. And, most famously, there is no haggling over the price of the car you buy. The price on the sticker is the price you pay.

CarMax's car-buying program is hard to replicate due to scale and the wide diversity of brands they sell. Obviously, if you are a dealer only selling Audi's or Ford's, you must find another home for a Jeep or a Chrysler. Even if you're part of a larger chain, many of the cars that come are simply not appropriate for resale. Your local dealer or dealer group simply doesn't have the heft or resources to "buy all comers" and find distribution outlets for them – at least not very profitably. CarMax does – and that gives them not only an inventory buying advantage but a share of mind among potential customers looking to sell *or* buy a car.

CarMax's no-haggle strategy keeps a certain number of potential customers away, since car buyers are accustomed to the haggling process after a century of conditioning. But for a large and growing segment of the used-car-buying population, the no-haggle model is very attractive—especially given used car dealers' reputation for deceptive negotiation.

CarMax now has a nationally trusted brand that it protects fiercely by living up to its reputation as a fair and honest dealer and using local and national marketing to reinforce the idea. In a business that sells a $20,000 item that could break down a day later and cost thousands of dollars in repairs, trust is THE paramount asset for a car dealer

CarMax has a few other advantages. As mentioned previously, its lots are much larger and carry far more inventory than nearby dealers, enabling CarMax to offer more choice—not only on its local lots but in its ability to have a car from another CarMax location shipped to your local store for a modest fee. In addition, given its scale, CarMax has far more data on each market's wants, needs, and supply of car inventory—meaning it makes fewer mistakes in inventory management as it exercises its ability to move cars from market to market as needed.

CarMax does not price its cars or extended service plans at a premium to other dealers, and the company earns a similar markup as its competitors. The company has created an attractive economic model for its shareholders in at least three ways, however:

1. By opening much larger-than-average dealerships in each major market, supplemented by smaller ancillary dealerships, CarMax is able to cover a market at an attractive overhead cost per unit sold, including the cost of reconditioning the vehicle, marketing it, and selling it.

2. CarMax earns ancillary revenue by holding major wholesale auctions to sell the cars it won't sell at retail. In fiscal year 2019, this was a major operation, involving the sale of 448,000 cars to other dealers for re-sale on their own lots, or to be parted out.

3. CarMax has a very attractive financing operation that has proven over its history to be a major source of incremental profit. CarMax Auto Finance—or CAF, as it is called—typically finances the ~50% of CarMax customers that are both interested in a loan and of prime creditworthiness. CarMax then securitizes (i.e., packages and sells) these loans to investors and earns the difference between the amount it pays to the investors (in FY 2019, about 2.4%) and the amount it collects from borrowers (in FY 2019, about 8%, including fees). Given that CarMax is allowed to earn a much higher interest rate than the third-party investors it sells its loans to, CarMax must also take the first position to accept losses—typically 1-2% of the total per year.

Automobiles—when underwritten sanely—are a very attractive category of loans. The U.S. as a country is extremely reliant on our cars, and most people are very reluctant to default on their car loan—if you can't get to work, you can't earn income. CarMax has complete knowledge of the loan's collateral (given that they bought and reconditioned the vehicle), collects the borrower's information directly (rather than through a third party, as many auto lenders must), and has almost no incentive to fool either themselves or the borrower, given that they are on the hook for the loan and also desire their business model to spread by word of mouth. This system has produced excellent and responsible results over many years, including during the 2008–2009 financial crisis.

Of course, not all applicants are in the prime category, and there is a bustling market for subprime auto loans. Rather than make those loans, CarMax chooses to refer subprime customers to other lenders—sometimes receiving a referral fee and sometimes paying one—but in both cases, avoiding poor credit risk. And, of course, roughly a quarter of CarMax's buyers either pay cash or arrange their own loans.

In essence, then, CarMax is part car dealer and part bank, and both parts seem to function well. Competitors have thus far tried to emulate the CarMax model with no great success so far—and CarMax continues to grow. In the coming fiscal year, CarMax will have completed the rollout of its "omni-channel" car buying experience that enables customers to buy a used car on their own terms—in a store, entirely online, or some combination of both. Early reports are that this program works very well, and we expect buyers to take CarMax up on its offer in growing numbers in the coming years. Given that CarMax still only sells about 3.3% of the units in its target market of used cars that are up to 10 years old, there is plenty of room for the company to run over time, even if the "full haggle" model does not disappear entirely (we doubt it will).

CarMax opens about 13 new dealerships per year on a base of just more than 200, representing growth of around 7% per year. In addition, we expect current stores to continue selling slightly more cars at slightly higher prices over time, as they have historically. The omni-channel initiative should supplement that further as CarMax captures a population of buyers that prefer the online experience. CarMax also repurchases its own shares regularly, in meaningful amounts. Adding up these sources of per-share growth, CarMax has historically grown its per-share earnings at a well-above-average rate, and we think it is positioned to continue doing that for many more years.

At the time of our original purchases, CarMax was trading at a sizeable discount to what we believed it to be worth on a long-term basis. Since then, its market value has risen faster than its intrinsic business value, as is often the case. In the coming year, the business may well outperform the stock to compensate. But as long the company continues to open new stores at attractive rates of return, maintain discipline in its financing system, and intelligently pursue its omnichannel business model, CarMax should eventually sell many more cars annually than it does today. If that is the case, the stock remains an attractive investment and we are pleased to watch it grow over time.

Home Depot

Home Depot had another good year. The company's 2,290 stores increased sales per square foot approximately 3.3%, with gross margins remaining at 34.4%—higher sales coupled with a high profit margin in this space leads to maximizing shareholder value. In 2019, Home Depot's sales of "big ticket" items such as appliances, lumber, and flooring increased—the average ticket sale was around $67.00, compared with $65.79 last year, representing a 1.8% 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 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 customer experience remains anchored on the company's principle of putting the customer first. During 2019, 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 as the company also remains focused on improving the interconnected customer experience in the store. In 2019, sales from Home Depot's online channels continued to increase, with an amazing 3rd quarter increase of 22% over the same period in the previous year—customers continue to respond to the ongoing investments and enhancements to the company's digital strategy. Home Depot also continues to leverage its digital platforms to drive incremental growth from adjacent categories like HD home, pool, and workwear and is experiencing good traction across all these categories. Home Depot's store relevance is paramount, as more than 50% of online U.S. orders are picked up in local stores. This is a testament to the power of Home Depot's interconnected retail strategy. During 2019, the company continued to roll out automated lockers in Home Depot stores to make pickup of online orders easier and more convenient. At the end of 2019, approximately 1,300 stores had lockers, and customer response has been outstanding—~95% of customers rated their locker pickup experience a 5 out of 5 stars.

In 2019, Home Depot focused on productivity and efficiency, with the goal of reaching more customers. The company is driving productivity and efficiency through ongoing operational improvement in its stores and supply chain. Home Depot is in the midst of spending $1.2 billion through 2023 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 distribution facilities across the U.S. that will enable it to 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 $10.10 per share in calendar 2019 (up 2% from 2018) and to increase earnings another 8% in calendar 2020—to approximately $10.90 per share. By staying focused on the four-legged stool of retail success, Home Depot continues to produce significant amounts of cash that it distributes to shareholders. The company will generate nearly $11.5 billion of owner earnings in 2020 and will return this cash to stockholders through share repurchases of approximately $5.5 billion and $6 billion of dividends (~ 4.8% forward pass-through yield at the year-end stock price). We are delighted with the company's ongoing focus on customers and shareholders and remain attracted to this one-of-a-kind specialty retailer that is sidestepping the retail disruption of online-focused e-tailers like Amazon.com.

Walgreens Boots Alliance

Although Walgreens Boots Alliance is a one-of-a-kind specialty retail firm that is focused on the healthcare segment, two recent issues have impacted its profit growth, valuation and subsequent stock price.

First, Walgreens (as well as other retail pharmacies) have encountered pricing pressure due to reduced reimbursements from insurers and lower prices on branded drugs. In effect, lower drug prices and changes in drug pricing have negatively impacted Walgreens' revenue stream as pharmacies receive a lower portion of a total drug's cost and collect a larger portion of their drug-associated revenue through dispensing fees. Bottom line: Pressured drug pricing means lower revenues and profits. Second, new competition is entering the pharmacy business that may or may not prove to be a threat to the traditional retail drug industry; for example, Amazon, a new entrant based on its acquisition of online pharmacy, PillPack.

Given this one-two punch, Walgreens is facing challenges, and the decision to keep or sell our investment in Walgreens during 2019 was not clear, as drug prices and dispensing fees will not go to zero (pharmacies are crucial players in the drug distribution business), and the impact of new competition from players like Amazon is not yet prevalent—even though the threat is real. Despite the issues related to lower drug prices impacting Walgreens, revenues continue to grow between 2% and 4% per year as the U.S. population ages and a greater number of individuals need medication in their daily lives. In addition, Walgreens is aggressively lowering costs to compensate for the revenue pressures of lower drug prices, having set a target of reducing annual expenses by $1.8 billion in 2022. As of this writing, Walgreens will annually produce approximately $5 billion in cash that will be available to shareholders. With a total year-end market value of $52.3 billion and owner earnings yield 9.5%, a surviving Walgreens would be considered extremely undervalued if current profit margins are retained. Tangentially: Walgreens also has a "hidden asset" in its 56,854,867-share ownership of AmerisourceBergen common shares, representing approximately 27.6% of the outstanding AmerisourceBergen common stock valued at approximately $4.8 billion.

Given Walgreens' low valuation, high cash generation, and hidden asset in AmerisourceBergen, the company has attracted investors that are interested in buying the company. A large private equity concern, KKR & Company, recently approached Walgreens with a proposal to take the company private. The deal specifics are not yet available, but there is history between Walgreens Boots Alliance and KKR—Walgreens' CEO, Stefano Pessina, worked with KKR in the past on the buyout of Alliance Boots, which eventually led to the merger with Walgreens to form Walgreens Boots Alliance. This is an important point, given that Mr. Pessina currently owns 16% of Walgreens' stock, has history with KKR, and would likely desire an opportunity to take the company private at a low valuation—both he and KKR would make a lot of money over five years from a surviving Walgreens.

This leads to our decision point. What should we do as current owners in Walgreens? We have recently re-evaluated our position in Walgreens, despite knowing that the company is likely worth more than its trading price— perhaps a lot more. This re-evaluation was necessary— if competition increases and margin erosion continues due to drug pricing pressures, Walgreens would likely be trading around its intrinsic value, and in the future may be worth less if competition and drug pricing pressure becomes more fearsome. In the meantime, if a buyout by Mr. Pessina and KKR occurs, current owners would likely be taken out of this position at a price that is lower than the company's true value. Given Mr. Pessina controls a significant portion of Walgreens stock, his vote will possibly sway the deal. In addition, Walgreens lower stock price has frustrated stockholders, and the uncertainty surrounding the retail drug business has created an environment whereby stockholders would likely vote positively for a sale – even at a low price. At the time of this writing, we have sold our position in Walgreens as we did not expect this investment to turn out like originally anticipated, regardless of whether or not a buyout occurs. In the end, a mistake was made due to my inability to properly judge the strategic position of Walgreens in an industry that is now facing significant disruption.

MEDIA & ENTERTAINMENT GROUP

Media and communications businesses continue 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 of advertising revenues into emerging new media companies continues to accelerate due to the disruption of "streaming content" offerings in this industry by companies like Amazon Prime, Netflix, Apple, 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 lower earnings generation in 2019. 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 (and Frozen 2, which came out in November 2019)*, 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 as 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 2019, Disney launched live-action films of classic characters: *Dumbo, Aladdin,* and *The Lion King*. In addition, *Avengers: Endgame, Star Wars: The Rise of Skywalker, Toy Story 4,* and *Frozen 2* also launched during the year—resulting in Disney's film division producing a blockbuster $11 billion year at the box office.

During 2019, Disney closed on a deal to acquire certain entertainment assets of 21st Century Fox for $71.3 billion in a 50/50 cash-and-stock transaction. This deal is a game-changer for Disney that has enabled the company to offer vast content on its own streaming platform, "Disney+." Disney+ generated more than 10 million subscribers within 24 hours of its offering—blowing past analysts' forecasts of between 10 and 18 million subscribers in the first year. In other words, Disney+ reached 50% of analysts' top projections for the year on the first day it was offered. We believe that Disney+ will provide a different and unmatchable streaming platform that will attract consumers worldwide.

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, growing international presence, and broad distribution capabilities will allow the company to extend its global reach for many even years to come. We remain enthusiastic owners of Disney, as the company continues to expand its global franchise, adding value for shareholders.

FIXED-INCOME INVESTMENTS

The Barclay's U.S. Aggregate Bond Index, which represents the broad debt market, experienced an 8.72% gain in 2019. In evaluating the current fixed-income market, we remain cautious over the long term with investing in most forms of fixed-income securities. 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(er) interest rate environment. For example, putting aside tax implications, if we purchased a 30-year U.S. Treasury bond on December 31st at a 2.39% yield and chose to reinvest the coupon payments into those same bonds at par, it would take more than 30 years to double our money. If we presented our clients with a similar arrangement to invest in a business at book value that produces a 2.39% return on equity and retains all the proceeds to repeat this poor return, our judgment would justifiably be severely questioned, regardless of whether the business was assured survival. Unluckily, today's absolutely abysmal return of 2.39% on a 30-year U.S. Treasury bond is guaranteed to lose money against inflation that will likely average more than 3% over the next 30 years (we will once again refrain from any forecasting). Nevertheless, many financial advisors 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, as they did during 2019—lower interest rates, investor panic, and/or deflationary pressures can attract additional money to fixed-income investments in the future, even at very 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 interest rates eventually rising and increasing chances of default among entities that are laden with debt. We remain concerned about low long-term market interest rates, which are destined to eventually move upward based on the Federal Reserve's desire to change direction on maintaining a low interest rate environment while economic conditions remain positive (i.e., low inflation and low unemployment). And so, as the economy continues to grow, the Federal Reserve has stated its desire for higher interest rates—we shall see how this aspiration develops in the future. Ultimately, the Fed's action to raise interest rates would 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, experience with other prophecies should illustrate that the crowd is often wrong. Market interest rates could unexpectedly move upward at a faster rate and/or sooner than anticipated, which would place tremendous pressure on low-yielding, long-term fixed-income investments.

In 2020, we have ongoing tranches of municipal and corporate bonds coming due. We will elect to reinvest the proceeds in shorter-term fixed-income instruments (mostly U.S. Treasury bills) going out three to six months, unless we can find a worthwhile alternative allocation among fixed-income securities that will provide a fair return over a longer term. In summary, we will continue to 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.

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WHAT'S NEW AT FOUNDERS?

Our firm remains fortunate to have individuals that possess a trait to care for others as they would themselves. This is a main reason we invest our own money alongside that of our clients. This "others-centered" versus "self-centered" mindset permeates Founders, and we remain proud of this special culture.

Transparency is paramount to the success of any partnership. We remain committed to communicating openly and fully with our clients and with each other. At Founders, we are sharing a greater portion of our duties within the firm, allowing everyone to grow in their responsibilities. Lisa has taken on greater operational and regulatory compliance duties. Ted administers our security filings with the SEC, facilitates and manages trading along with relationships with trading firms, undertakes equity research, assists with portfolio analysis, and works on capital allocation. Jeff primarily conducts broad equity research and works on capital allocation—especially large commitments like CarMax and Wells Fargo, which we instituted this past year. Our interconnected activities ensure sustainability for the firm and for the assets we are charged with managing. I could not be more enthusiastic about working with such talented and skilled individuals every day.

Each of us at Founders Capital Management remains grateful for your business and for your 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 2020.

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

(1) the 10 largest equity positions held by Founders' clients;
(2) 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.

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 them 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 businesses 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**—seek to maximize cash yield spreads and practice short-term and long-term arbitrage
- **Practice 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—**THIS IS A RECIPE FOR EVENTUAL FAILURE

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Investing for the Long Term. Every Day.