Sustaintability & Security

FOUNDERS CAPITAL MANAGEMENT
2021 ANNUAL REPORT

Investing for the Long Term. Every Day.

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

2021 Annual Report:

"Sustainability & Security"

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2021 INVESTMENT TEAM LETTER
From: Founders Capital Management

"Sustainability & Security"

"We must shift our thinking away from short-term gain toward long-term investment and sustainability, and always have the next generation in mind with every decision we make."
—Deb Haaland, U.S. Secretary of the Interior

From the very beginning of our firm nearly 20 years ago, Founders has been fortunate to develop a strong base of client partners that we feel are the best that can be imagined. Over time, our clients have become more than acquaintances—more like family than friends. It amazes us that we now have instances of three generations of wealth in families that have placed their trust in Founders. Great responsibility comes with this honor. Our clients' long-term faith in Founders obliges us to think about sustainability and security—not just for the next five or 10 years, but over the next several decades.

Our focus in the 2021 Annual Letter is on business sustainability and security. Our experience has shown us that various businesses fall short in this area, despite a strong desire to succeed. In fact, the will to cultivate a sustainable and secure business is more important than the desire to succeed. In this letter, we will consider the sustainability stories of various businesses we have studied, covering both successes and failures. Ultimately, our goals are to isolate what it takes for a business to achieve sustainability and security and to emphasize the importance of these company attributes when investing.

A story: A chicken farmer decided the time was right to discuss the passing of the family land to the next generation. He was sitting over breakfast with his children thinking about the best way to explain the importance of sustainability and security for the family farm into future generations. He looked over the egg breakfast on the table and decided to ask a question: "Which is more important in providing our breakfast each morning, the chickens or the eggs? The children all chimed in, debating the importance of the chickens vs. the eggs to their delicious breakfast. The first child said the eggs were the most important part of the breakfast, since they provide nourishment for the family to work each day on the farm. The second child was unsure that either was more important, because it is the combination of the chicken's effort and her ultimate eggs that powers the family to manage the farm. During the debate, one of the farmer's daughters remained in thought, and finally the father turned to her. "What do you think, Mary?" Mary looked at her father and said, "Father, the chickens are more important than the eggs and remind me of running our family farm." Perplexed, the father asked, "What do you mean, Mary?" Mary replied, "The chickens are involved every day in giving us our eggs, and without them we would not have any breakfast. Each chicken commits its life to producing eggs that provide us the strength we need to manage the farm." The rest of the children nodded and agreed. The father knew right then that his children understood what was necessary to ensure the sustainability and security of the farm for future generations—caring for the chickens, as opposed to protecting baskets of eggs, was more important to ensuring the farm's long-term success.

In this story, the intelligent farmer knew all too well that the chicken farm's value was closely linked to the chickens that would lay an ever-increasing number of eggs. He recognized that his job, therefore, was twofold—to provide a secure environment in which the chicken flock could multiply and continue producing eggs, and to have a predictable view of the

number of eggs the chickens would produce today as well as many years out. Very few chicken farms, of course, fit the description of a sustainable growing egg producer—so when a farmer owns one, it usually pays to hold on to it for generations.

The objectives of the successful investor are no different than those of this chicken farmer—just replace the chicken farm with a business and the eggs with money. Every investor wants to own sustainable and secure businesses in which he can ascertain, with a high degree of certainty, the value of money today produced over a business's life. But there is caution in our story for investors—just as a farmer that focuses on chasing baskets of eggs rather than keeping his eye on the chickens will eventually lose the whole flock to the wolf, an investor that opts to focus on chasing baskets of money rather than keeping his eye on the businesses he owns will eventually lose his portfolio to the wolf of Wall Street. The investor who knows the price of everything and the value of nothing loses sight of his investments' sustainability—eventually he will go bankrupt and lose his security as well.

This year's letter will delve into the important attributes of sustainability and security that are necessary to create value in a business, including our perspective on the succession of business "culture"—the epicenter of long-term business sustainability and security. We also believe that entrenched character in a business—honesty, integrity, transparency, trust, and complete caring—ultimately leads to sustainable value creation. Businesses that adhere to these guiding principles will stand the test of time and continue to benefit future generations.

* * *

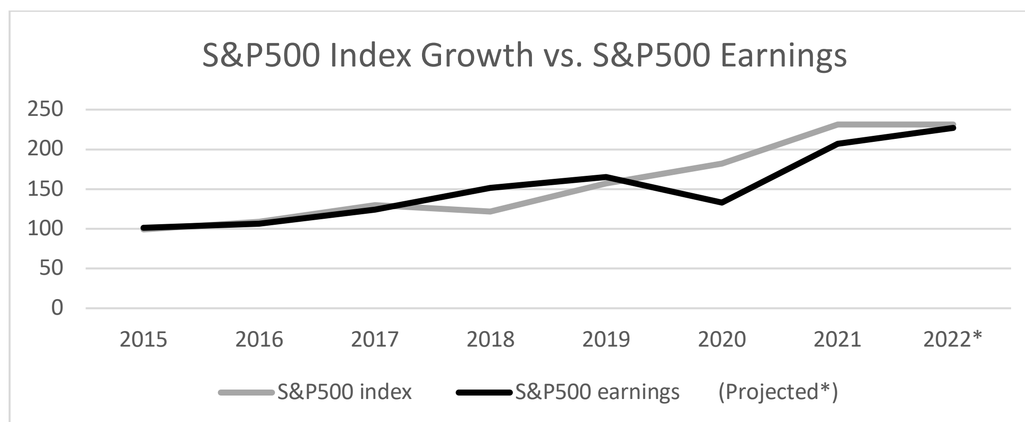
It's fair to say that the stock market has been schizophrenic during the past few years. The S&P 500 did a sudden 16% nosedive during a three-week period in December, 2018, followed by a market recovery over the next 14 months that led to a 44% increase in the S&P 500 by the first quarter of 2020. Just when everything looked rosy again, the index did a 34% freefall in just 33 days due to the sudden emergence of COVID-19. Following this precipitous drop, the S&P 500 rose a stunning 67% by the end of 2020. Based on this rapid recovery, market forecasters predicted that the market would struggle in 2021—wrong. The market had a surprising rise during 2021, with the S&P 500 ending up at a 28.7% gain for the year. So much for expert opinion.

In hindsight, it seems that the only consistency in the stock market over the past seven years has been a roller coaster ride that has left investors jittery and more convinced than ever that the stock market is essentially a casino in which betting on short-term market swings allows both bulls and bears to make money. And it is our opinion (and that of many others) that stock market gambling reached new heights this year. This "gambling" activity in certain pockets of the market that has led to popular stocks to be extremely overvalued, does not necessarily mean that the aggregate stock market is overvalued, however.

Whereas in the past, when many investors wondered—justifiably—if being involved in a gyrating stock market was worth the pain, overall investment sentiment has taken a turn from cautious pessimism to unchecked optimism over the past 18 months. We've watched new investors jump into the "game" to get a piece of short-term gains from "meme" stocks—companies with low revenues and profits—trading at multibillion dollar valuations. The type of disruptive news that would blow through the stock market in the past like a violent wind, accelerating price movements up or down, has been replaced with a new kind of market disruption: Any company that has the words "cloud computing," "cryptocurrency," "electric vehicle (EV)", or "biotech" associated with its business is being gobbled up at *any price*—assessing value has little meaning. We've watched rational behavior go out the window when, for one example, a company with zero revenue and more than $3.5 billion in projected losses is able to go public and support a market valuation exceeding $100 billion during its first day of trading—while a company such as 3M, with nearly $6.0 billion in annual profits, barely trades at the same $100 billion market valuation. **Yes, this is a warning that this behavior will end someday, and badly—we just don't know when.**

Despite this bookmaking behavior in the stock market, however, when we step back and evaluate the longer-term trend, we can see that the market's overall movement continues to add up to strong gains in intrinsic value

over time. An update to last year's chart assesses gains in price vs. earnings for the S&P 500 over the past eight years (assuming zero expected market gains in 2022):



If we had placed $100 in the S&P 500 at the beginning of 2015, that investment would have turned into approximately $231 dollars at the end of 2021—reflecting an annual return of approximately 12.7% over seven years. Now, let's assume (we're not predicting—this is just an illustration) that the S&P 500 stays flat during 2022. Under this scenario, an investor's eight-year annual return would adjust to 11%.

As a comparison, if we look at the growth in *operating earnings* for all companies in the S&P 500 over the same seven-year time period, the S&P 500's collective operating earnings would have grown from approximately $100 to $207 per share by the end of 2021—representing an annual increase in S&P 500 operating earnings of 10.95%. If the expected operating earnings for the S&P 500 grows to $227 in 2022, the annual growth in operating earnings would turn out to be approximately 10.8% over an eight-year period—nearly equal to the growth in the S&P 500 index in our outlined scenario.

The salient point: Although the S&P 500 index's extreme price gyrations over the years resulted in drops and surges in excess of 30%, in our presented case investors that take a 96-month holiday from watching the market would come home to investment gains that nearly mirror the increase in operating earnings of the S&P 500 companies.

A final point in our introductory section about the stock market: As we've watched rampant speculation taking place in various securities, we've remained adamant about not buying any of the highfliers that have investors excited about the prospect of "quick and easy" short-term gains. Why is this? When we group the top seven high-flying companies that went public during the past 18 months, the folly of extreme irrational investment behavior is plain to see: These "top seven" will collectively produce approximately $9.5 billion in revenue whole losing ($2.1) billion in 2021—and yet at the time this is being written these seven companies trade at a collective market value of $427 billion. Let's forget that there's less-than-zero collective profits for this group—*the market is placing a value on these entities that is nearly 45 times their collective revenues!* Assuming the speculative behavior continues, perhaps the collective market capitalization of these companies will reach $1.0 trillion, or maybe $3.0 trillion—it doesn't matter, as in these cases, actual value is not part of the investor's equation. The only rationale for participating in these speculative securities is a hope that the stock prices continue to rise. It is our experience, however, that this will end terribly. The odds of making money on these types of investments over the long term are low, and the probability of predicting a positive near-term outcome on any investment in these entities is likely even lower. We applaud the lucky gamblers that make money in these rare cases, but we gladly walk away from casino-like behavior that leads to losses nearly 100% of the time.

Sustainability and Extreme Speculation

After reflecting on the events of this past year, we realized that the only thing worth expecting is the unexpected, and that regardless of the issue— whether COVID-19, world politics, or investment interest in extremely overvalued stocks, or disinterest in undervalued companies—there's one thing you can always count on: Strong differences of opinion. Like others in the investment business, we have found recent events difficult to navigate when allocating capital. How should one make investment decisions amid such extreme polarity in investment activities and views?

Many market participants have found it convenient to gather investment information from heated discussions taking place on social media platforms. Social media provides a forum for sharing content anonymously, creating an opportunity for the most impulsive of human reactions to flourish. The days of civil investment discussions are likely behind us; a scroll through the comments section of any popular investment site is all it takes to get anyone's adrenaline flowing these days. In platforms such as Reddit, Robinhood, and Webull, the exchange of investment ideas seems to amount to people plugging their ears and simultaneously yelling the loudest. Instant information provided on social media platforms—and the hyperbolic nature of the communication it engenders in the platforms' various communities—is here to stay, and the investment community is no exception. Suddenly, ideas are reinforced because a single (algorithmically targeted) article pops up on our feed and "confirms" an already biased investment opinion.

What makes the market so divisive today? For one thing, we've never seen a market with so many security offerings. The days of investing in stocks and bonds mainly by evaluating a company's fundamental financial performance are long gone. Instead, the current U.S. market has ballooned to more than 6,000 equity mutual funds and ETFs, weighted in proportions that are different from the approximate 6,000 individual companies listed on the U.S exchanges. The number of security offerings is not the only thing swelling—during 2021, the stock market absorbed $1.0 trillion of new investment, with a large portion going into newly minted speculative stocks. The tsunami of money that flowed into the stock market during the past 12 months exceeded that of the past 20 years combined!

In addition, there were more than 7,000 types of cryptocurrencies as of December, 2021, according to price-tracking website CoinMarketCap, with a market capitalization that exceeded $3 trillion. The entire U.S. stock market had a market capitalization of around $53.4 trillion at the end of 2021, which means cryptocurrency is now 5.6% the size of the U.S. stock market. Why is this worrisome? A cryptocurrency such as Bitcoin (Bitcoin currently constitutes approximately 40% of the value of all cryptocurrencies) was invented in 2009 but did not begin trading until 2015. It wasn't until 2017 that the Bitcoin investment craze began, and the price skyrocketed—from around $1,000 per coin to over $67,000 per coin at its high in November, 2021. The recent success of Bitcoin led to an explosion of copycat cryptocurrencies, resulting in a multitrillion cryptocurrency market in just four years.

In 2021, an investment in one Bitcoin on January 1st returned 146% if an individual was able to perfectly time their trade and sell it at its high in November. This is impressive if you're looking solely at numbers. But an individual considering a position in cryptocurrencies should ask herself: "What is the underlying basis of the asset and its associated return?" As cryptocurrencies continue their reign of popularity, proponents justify the legitimacy of the asset by its surging price. Bitcoin even coined a catchphrase that populates many investment forums: "Bitcoin to the moon!" Basing the quality of an investment on short-term, positive price returns is a fool's errand, and one that has been repeated throughout history. The Dutch Tulip Crisis of 1637 comes to mind. For those unfamiliar: Starting in 1634, market speculation drove the value of specific breeds of tulips to extremes. While the beauty of the flowers can be universally appreciated, the price surge that took hold on these specific flowers quickly proved that this was a fad divorced from rationality. Unfortunately, some caught up in this craze had sold entire homes to purchase a single bulb that was "rare" or "uniquely beautiful," with the hope that holding it would increase its price. Eventually, the tulipmania died abruptly, and those who'd overspent with the intent to "invest and make quick money" trading rare tulip bulbs were financially destroyed.

"History does not repeat itself, but it often rhymes."
—Mark Twain

We can't help but notice the parallels of this mindset to modern-day Bitcoin. Bitcoin does not produce a product, service, or any type of earnings but is widely regarded as a must-own asset for anyone looking to include currency in their investment portfolio. But many great minds—including J.P. Morgan CEO Jamie Diamond and Berkshire Hathaway's Charlie Munger and Warren Buffett—take a completely opposite view, arguing whether Bitcoin can even be considered a "currency" at all. While Bitcoin can be used to facilitate a transaction, it is not backed by any underlying value other than faith in the counterparty. Relying on good faith is a questionable practice when it comes to an asset that bears the name "non-fungible token" (NFT). Some advocates compare Bitcoin to the U.S. dollar, reasoning that the U.S. dollar is also not backed by anything. While it is true that the U.S. dollar is a free-floating currency not anchored in specific assets, the currency is grounded in the validity of the U.S economy and the ability of the U.S. government to tax its citizens as well as domestic and international corporations doing business within its borders. Essentially, one could argue that the U.S. dollar is a fungible asset backed by the compiled production of the U.S. itself. We would gladly bet on the U.S. continuing its ability to sustain the value of the U.S. dollar over the word of a group of anonymous individuals adhering to a conceptual digital value. Unfortunately, the value of the non-fungible token may eventually live up to its name—*non-fungible,* i.e., *worth(less)*.

The recent extreme influx of investment into the stock market and a new type of asset class (cryptocurrency) poses potential risks for millennial investors, who constitute a large portion of the investors buying these popular assets. Millennials, in particular, are at a crucial spending point in their lives, with many purchasing a first or second house. During 2021, the price of a typical 2000 square foot home experienced an 18.6% price increase—the biggest increase in 45 years—that was absorbed primarily by millennial buyers. Much of this increase was due to low borrowing rates, but a portion was also due to gains achieved on investments in speculative assets. This generation may have come to believe that speculative investment returns will continue to keep up with housing costs, and this could spell disaster if these inflated investments take a drastic turn south. While times are good, these speculative investments appear to have paid off, but one must keep in mind that there has been a very short window of time for making a determination about whether these assets and their returns will end up being sustainable.

"Good times become good memories; bad times become good lessons"
—Unattributed

Sustainability and Business Disruption

Looking beyond the speculation-driven investment crowd to broader investment activity: It seems that most professional money managers these days are ignoring "stodgy old" companies that appear to provide lower-then-average returns. Their interest has moved to high-growth, disruptive businesses that they believe will provide "better-than-average" investment returns. Professional investors buying emerging businesses that promise "high, immediate returns" but that actually come with less certainty and little to no economic value rationalize their actions with this belief: "To obtain higher returns, we need to invest early in recognized disruptive companies that have a long runway into a new future." In their thinking, to obtain high-octane returns, you need to get on the bandwagon and chase rising stocks of businesses that have the potential to achieve the greatest disruption and highest increase in price—value becomes meaningless.

Let's consider the logic of investing in the "disrupter" category: Imagine if we had the opportunity to make a lifetime investment in a group of graduate business students in exchange for a portion of their future earnings. To evaluate our most promising prospects, we likely would not seek the most disruptive students in the class, nor the ones that are most adept at sustaining havoc. We would probably look for the smartest students that were consistently honest, hard-working, critical thinkers that acted with integrity and brought out the best in others—in other words, prior to investing money, we would identify the graduates with these sustainable attributes, as these intrinsic qualities would provide us a sense of long-term security in our investment. The

overzealous “disruptive students” may be good at providing a “long runway” of mayhem as they kick up excitement and get our attention in the current moment, but the performance of most over the long term would likely end up revealing them as graduate “business imposters.”

Nevertheless, based on the advice of "expert stock-pickers," many believe that achieving gains in today’s market requires figuring out how much disruption a given business can create and how long it can sustain the instability in its industry, disregarding whether the business has attributes required to create long-term, sustainable intrinsic value. Many emerging businesses tend to have questionable customer and shareholder loyalty, ever-changing strategies and products, little to no profitability, and are managed to entice impulsive investors. Because these companies produce little to no money, the measures to value them include nothing we can truly assess with accuracy—such as numbers of future customers or users—while all-important intrinsic value measurements are thrown out the window. In our view, **you can’t measure the distance someone walks by counting the number of times they tap their feet.**

As a long-term investment strategy, placing money in disruptive businesses is likely not sustainable. We believe that investors should evaluate businesses using criteria similar to those one would use to identify successful future business graduate students: One should seek sustainable and secure businesses that have intrinsic values that are measurable today and are highly likely to strengthen over time.

Sustainability in Business & Investing

“To finish first, you must first finish”
—Rick Mears

This saying that has been cited for years in car racing circles applies to investing: To finish first when investing, you must first finish. You will always have winners and losers when you allocate capital, but it is important to ensure investment sustainability and security over the long term. Many market participants learn this too late. They start investing by placing small sums in speculative businesses and take their winnings off the table as stock prices rise. Eventually, they decide to repurchase these stocks and increase their wagers in speculative businesses as they watch others experience ongoing success, driven by a fear of missing out. Ultimately, "risk-creep" enters their portfolio, and speculation exceeds investment. (When the crowd is chasing money, it is human nature to follow the crowd.) Eventually, speculative behavior ends, and aggressive selling of these stocks occurs as emerging companies prove to be business imposters, and the naive investor (even professional) is taught a severe lesson as they watch years of accumulated wealth evaporate in a few months.

Sustainability and security when investing in the stock market is rooted in sustainability and security in the companies that one invests in as well as in the management of each business. "Business sustainability" is a term that seems to be used quite a bit today when evaluating companies, and so we think it is a good idea to review this term in-depth from the perspective of an investor, or business owner.

A "sustainable" business today is primarily thought of as one that has minimal negative impact—or potentially a positive effect—on the global or local environment, community, society, and/or economy. The overarching concept is that a sustainable approach to business creates long-term value for all constituents if the organization operates in an ecologically, socially, and economically responsible fashion. Sustainability is built on the assumption that developing sustainable strategies delivers company longevity. Increasingly, companies that do not practice sustainable business practices are shunned—investors move their capital to companies that have favorable Environmental, Social and Governance (ESG) metrics. (ESG ratings are designed to measure a company's resilience to long-term environmental, social and governance ESG risks, and they are published.)

As investors, we need to ask: What effect does a particular business have long-term on the environment, local community, and society at large? And what effect does the business have long-term on the global social fabric? Sustainable business behavior makes sense—companies that fail to employ sustainable business practices often end up featured in press coverage outlining their transgressions in areas such as environmental degradation,

economic inequality, and social injustice. Of course, news stories are often sensationalized—written in a way that grabs our attention without going into much depth about issues that can be complex—and thus require deeper consideration.

To illustrate this, let's look at some examples of complex issues occurring with companies that are currently held as practitioners of outstanding sustainable behaviors that other companies should follow (we will not reveal the company names, as our focus is on the sins vs. than the sinners):

1. A number of apparel companies that have started focusing on sustainable business practices such as creating a green supply chain to source their material, eliminating plastic bags, and using environmentally friendly dyes to produce their clothing have been placed on a business sustainability pedestal. These companies are touted via ESG metrics as highly recommended for investors to pursue. One of these companies, however, was cited not long ago for endorsing child labor and supporting labor abuse in the production of its products. Taking a deeper look, it turned out that to maximize its profits, low-cost production was required. Subcontractors were hired to produce this company's products in developing countries, and these organizations abused labor through long hours and low wages, including hiring children. Once it became aware of the inhuman practices, the company addressed its supply chain issues to ensure proper labor practices throughout the production of its products—but there was a period of time when outsourcing its production to uncontrolled entities had led to socially unacceptable human rights transgressions. Based on its long-term sustainability practices, should an individual shun or invest in this company?
2. In recent years, some large consumer goods companies have started to make major commitments to sustainability through such practices as replacing environmentally harmful ingredients with organic ingredients such as palm oil and reducing their resource footprint to protect the climate, reduce waste, and maximize efficiency. One famous consumer goods company that has been on the sustainability pedestal via ESG metrics has been boycotted for several decades for causing illness and infant deaths in poverty-stricken communities in developing countries. Advocacy groups and social rights organizations have accused the company of using unethical marketing practices to promote its infant formula products (powdered milk), which is less healthy and more expensive than breast milk. In severe cases, starving mothers are unable to breastfeed due to an inability to produce enough milk. Thus, they rely on free powdered milk as a supplement from nonprofit organizations and either inadvertently mix it with tainted water—or overdilute it to feed more than one child, lacking the understanding that overdiluting the formula could prevent a child from absorbing the nutrients—leading to infant malnutrition and deaths. While the company provides guides and works with and supports organizations that teach mothers in developing countries how to mix powdered milk with untainted water to feed newborn children, many mothers in developing countries are unable to read or don't follow the directions. Based on its long-term sustainability practices, should an individual shun or invest in this company?
3. Several beverage companies have developed ambitious sustainability goals such as increasing their focus on water stewardship and setting targets for water replenishment. For their water conservation practices, these entities have been promoted to the ESG pedestal and cited as examples for other companies to follow. In the past, however, one beverage company was accused of dehydrating communities in its pursuit of water resources to supply its local bottling plants, drying up farmers' wells and destroying local agriculture. In some places, the company's activity led to increased hunger problems and farmer bankruptcies. Yet today, this company has set a goal to achieve 100% sustainability on water replenishment in water stressed communities. Based on its long-term sustainability practices, should an individual shun or invest in this company?

When we consider an investment at Founders, we place a high emphasis on business ethics. We understand, however, that unintended consequences of business activities aren't always clear-cut. Collectively, the Founders team has studied the 50-year history of just about every large company on the planet. In the process, we have come to understand that companies are made up of human beings, and human beings are far from

perfect. Even companies that stand out as having high ethical standards can present challenging situations that an investor has to assess. When we encounter these issues, we ask: Were the consequences unintended and unforeseen, and did the company take responsibility and invest in solutions to rectify problems when they surfaced? While we dislike the "sin," we understand that unintended consequences can happen in a complex business. Ultimately, we seek companies that recognize harms quickly and fully pursue rectifying the consequences of unintended, wrongful behavior.

On the other end of the spectrum, we abhor certain sins and will not invest in businesses that behave in an unethical manner. For example, if a company purposely alters its accounting, creating financial statements that are intentionally incorrect to defraud investors, we *never* invest—and this happens more than most people realize. If a company intentionally alters its products for decades to make them more addictive to customers, with full knowledge that its products are a health hazard (certain tobacco companies), we *never* invest. If a company knowingly runs an unsafe chemical plant that leads to the world's deadliest industrial disaster and never takes full responsibility, we *never* invest. (The clean-up in this case is still in process, and tainted water has existed for more than a generation at this point due to this company's ongoing failure to take full responsibility for its business misconduct that has caused thousands of deaths.)

In our view, deliberately creating societal fraud that permanently impacts the social fabric falls into the "unforgivable" category. We will not invest in such companies today at any price—no matter how strong their business.

Sustainability and Value Creation

Digging more deeply into the concept of investment and business sustainability—a responsible investor does not act like a gambler who makes uninformed guesses about the next anticipated roll of a stock. Instead, he works to understand what truly "counts" when seeking companies in which to place funds. In past letters, we identified what we believe counts when determining the difference between "what value is" and "what is valuable." We believe valuable businesses to possess the "four 'ables' ":

- **defend*able*** businesses that are difficult for competitors to penetrate
- s**ustain*able*** businesses that can be viewed many years out
- **predict*able*** businesses that have a high market share of consistently needed products that are integral to daily activity—leading to steady returns on capital and profitability
- **afford*able*** businesses that are selling at a desirable price that provides an investor a fair return over time

Review of Sustainable Economic Value Creation

Businesses that possess the "ables" create economic value by producing distributable owner earnings over time and reallocate a portion of their earnings effectively to achieve future growth in intrinsic business value. We have stated previously that corporate earnings should not be viewed on an apples-to-apples basis due to variations in the capital-intensity of one business compared to another. For example: A capital-intensive automobile manufacturer participating in an industry that tends to exhibit self-destructive competitive pricing behavior may achieve an average return of 8% on its employed capital. In a typical automobile business, for every $3 per share of earnings reported, the carmaker *must* retain $2 to enable the company to stay on the competitive treadmill—therefore, little of this money can make its way to the company's owners. As much as management may try to generate cash for shareholders, the automobile manufacturer has to retool and/or build factories to produce new cars for future delivery. This type of business thus places a heavy burden on its retained shareholder earnings, requiring management to achieve an equal or better return on freshly invested capital compared to prior returns on retained equity. If competitive pricing wars mount in the automobile industry, and management fails to obtain a return on this reallocated shareholder capital that is equal to or better than what was achieved in the past, economic value is destroyed over time. This example encompasses *all* automobile manufacturers in the industry, including the disruptive, much-hyped electric vehicle makers that are cropping up around the globe.

On the opposite side of the coin, a well-entrenched, non-capital-intensive business has a tendency to gush cash (for example, PepsiCo's manufacturing of syrup and snack foods does not materially change). A beverage and snack manufacturer that is able to achieve a consistent 25% return on employed equity capital has difficulty reinvesting 100% of its earnings, since doubling this global business every three years would be difficult—every $1 of shareholder funds retained would turn into more than $9 in 10 years. If this investment dream could come true, however, owners would request that management retain all capital possible to increase returns cumulatively and exponentially. Understandably, most businesses that generate returns of 25 cents on every $1 of employed equity capital would find it very difficult to reinvest undistributed capital on a continual basis to achieve a growth rate of 25% per annum. Thus, these excellent businesses generate a large amount of unrestricted earnings that, in principle, should be distributed to shareholders through dividends and/or prudent share repurchases. Many investors these days don't desire businesses that are far from disruptive and cannot grow at 25% per year. But *we like this category of businesses—a lot. They remind us of the sustainable and secure chicken farm that continually increases its egg production over time.*

A final point: Any business that produces zero or negative earnings (and is experiencing fast growth) must constantly raise money from investors to stay alive. For example, if a company loses money on each $1 per share of employed equity capital and needs $2 per share to support future growth, management must raise fresh equity capital by issuing new shares to meet the company's appetite for continued growth. This type of business places a negative burden on its shareholder equity, requiring management to *someday* achieve a return on shareholder capital. If management fails to eventually obtain a return on shareholder capital, economic value is more than destroyed—it becomes permanently elusive, with bankruptcy imminent. Value creation is more nebulous and difficult to judge in these businesses, since earnings on deployed shareholder capital are unforeseen and farther out in the future. Market participants seem to love these newly minted companies that promise a bright future—when some of these businesses issue shares to the public via an IPO, their stock prices can be bid up to the stratosphere. In reality, there is a high probability that perpetual earnings of *less-then-zero* will stay intact for many of these businesses—leading to unsustainable economic value destruction. The stock prices of these entities eventually come back to earth and align with their perpetual negative return on shareholder equity capital—*zero*.

Sustainability and "Trust (but Verify)"

We believe that sustainable business behavior ultimately comes down to trust. But as the late President Reagan stated, "Trust, but verify." Trust, in our view, should be verified and evaluated by an investor that has followed a company over many years. It is also our view that trust is something that is earned on an ongoing basis and should not be regarded by a company's leaders as an entitlement. Leaders and managers of all companies want investors to trust their stewardship, and their ongoing actions should reflect their desire for trust. Every business leader understands the consequences when customers and investors lose trust—they personally will not succeed, and/or the business will eventually go bankrupt.

One way to verify trust in a business is by reviewing incentive systems the organization has established to guide behavior—as investors, we believe that proper incentives will drive sustainable behavior. In our experience, when incentives are misaligned within a business that seeks to create long-term intrinsic value for all stakeholders, everyone involved suffers to some extent—including shareholders. Additionally, when incentives are misaligned with long-term business goals, this is when transgressions occur. Wells Fargo provides a recent case in point. The monetary incentives the company put in place for employees that were dealing directly with customers led the employees to open fake accounts and cross-sell products that clients did not need. This poor incentive system is now deceased, but only after clients and shareholders had paid a tremendous financial price. The management team was fired for these abusive client transgressions, despite not fully understanding the depth of the poor incentive system that had impacted their employees and customers. Also, upon learning that the incentive system put in place to grow Wells Fargo's customer share had led to egregious conduct among its employees, management attempted to play down the impact of the transgressions—this is where the ultimate sin occurred and led to the Wells Fargo management team being

fired. The new Wells Fargo management team eliminated the perverse employee incentive system and is pursuing to set an example with regulators to achieve "best customer care" in banking.

So, why haven't we sold our stake in Wells Fargo? We think Wells Fargo is on the path to establishing the highest ethical standards in the banking industry. Unfortunately, when we studied banking industry incentive systems, we discovered activities similar to Wells Fargo's original transgressions in practice at competing banks. For example, one large bank incentivizes customers to move their investment accounts to its bank in exchange for a lower interest rate on a home mortgage or refinancing. This "tying of products" (in this case, investments and mortgages) is exactly the type of activity that got Wells Fargo in trouble. In other industries, tying products together as part of the sales process is illegal. We've concluded that the banking industry needs an overhaul of its incentive systems, and we hope that all banks end up following Wells Fargo's new leadership in this area —if not, they can expect to face similar heavy penalties.

The financial service industry is unfortunately ripe for offering a further example of a perverse incentive system. As a result of commission-free trading, investors flocked to the global stock market in 2021, adding approximately $1 trillion of new capital—a sum greater than the cumulative $800 billion of new investor capital added to the global markets from 2001 to 2020. One brokerage firm that went public this year touts its mission to "democratize investing." New investors point to this new type of brokerage firm as an example of the "modern Wall Street," where investors take control of their own destiny. Offering commission-free trading and IPO access, millions of new investors clamored for this company's mobile application and opened investing accounts.

The obvious question: How does this company make money? Market makers compensate the company for directing customer orders to different parties for trade execution. In other words, customers pay commissions behind the scenes without knowing it. Nevertheless, the concept of "free investing" has created a perverse incentive system for investors to gamble when investing, especially through trading via the options market through this brokerage firm's mobile application (trading options incurs high commission costs at other brokerage firms). Warren Buffett described this as casino-like activity: "American corporations have turned out to be a wonderful place for people to put their money and save, but they also make terrific gambling chips. If you cater to those gambling chips when people have money in their pocket for the first time and you tell them they can make 30 or 40 or 50 trades a day and you're not charging them any commission but you're selling their order flow or whatever...I hope we don't have more of it."

The gamification of investing is an example of deliberate *unsustainable* behavior that will ultimately exact a cost—eventually, this behavior will break the "rule of trust" between investors and the firms they relied on to provide them access to the markets. Thus, we will not invest at any price in a business that promotes this activity.

A final point about trust: Shareholders naturally expect (and deserve) to be able to trust the managers overseeing the capital they have placed in their hands. It should be assumed without question that business managers will treat investors the way they would like to be treated if their roles were reversed. In turn, what should managers of public companies expect from shareholders? Many managers running public companies generally mistrust their investors. Why is this? In most cases these days, shareholders don't hold on to a stock for more than a year—their goal is simply to make a quick dollar, without any regard for the efforts of management working to build long-term value on their behalf. This "short-termism" that engenders mutual distrust between management and investors is unsustainable in a capitalist system. An argument can be made that, in many cases today, neither investors nor management are acting in a sustainable fashion—and this will inevitably lead to long-term loss of trust in a society that relies on the mechanisms of capitalism. This damage would be more pronounced for the millions of people across America who rely on the proper functioning of the markets to support their future retirement—given that the markets are where their retirement money resides. A mutual "carrot of trust" needs to be cultivated between management and shareholders to support a sustainable future in capitalism.

Sustainability and Business Culture

The concept of "corporate culture" has been defined in various ways by business pundits over the decades, but it is still difficult to describe, let alone pin down. Most businesses work to establish a business culture that enables the business to thrive over the long term—just as most families maintain "cultures" that are made up of value systems that are passed on to future generations. An ever-changing and integrated society makes it impossible for any culture to stay static, however—it must evolve or else die.

We believe that certain aspects of any culture should stay static, while allowing for other facets to evolve. An example of a business practice that should be enduring: If all business leaders thought of fellow owners, employees, and customers as partners, they would naturally approach decision-making in a balanced manner, and open and transparent communication—both inside and outside of the business—would prevail.

In any enterprise, mistakes will inevitably be made. They should be faced head-on, as opposed to being swept under the rug. Solutions to business mishaps should be explained to all partners with an understanding that similar shortcomings should not be repeated. Leaders should emphasize what has been learned from the experience and put steps in place to ensure that the mistakes are not replicated in the future.

Transparency and communication—both formal and informal, and both internal and external—are a must for every business. Any type of bureaucracy that works to dismantle business communication should always be avoided—this can lead to transgressions, as individuals attempt to circumvent red tape. On the other hand, bureaucracy intended to ensure business integrity should be embraced—for example, compliance to Security and Exchange Commission (SEC) standards in the financial industry should be fully adhered to by advisors.

We also believe that businesses should promote an “others-oriented” vs. “self-oriented” ethos. Others-oriented behavior bolsters business integrity and cultivates a high security quotient within the organization—like building a "strong ego" vs. "big ego" culture. A few other sacrosanct principles for any business pursuing a positive corporate culture:

- **Act with Character**—This one is hard to describe, but we all know it when we see it (when in doubt, always place others’ interests before one’s own).
- Act with the “Rs” in mind: **Reputation** (never lose it), **Responsibility (**always take it), **Reliability & Results (**focus on execution).
- Business leaders should be guided by the “Ls”: **Lead with Love**, reinforce the organization’s ability to **Learn to Learn** (become an organizational “learning machine”), and **Live for Others—Look and Listen** for human growth orientation. (Remember that hoarding knowledge is like hoarding love—the more you keep it to yourself, the more you lose it.)

Warren Buffett described the attributes of a great business manager in Berkshire’s 1986 annual shareholder letter: “Our prototype for occupational fervor is the Catholic tailor who used his small savings of many years to finance a pilgrimage to the Vatican. When he returned, his parish held a special meeting to get his firsthand account of the Pope. "Tell us," said the eager faithful, "just what sort of fellow is he?" Our hero wasted no words: "He’s a forty-four, medium."

It's that simple: The best business leaders and managers will succeed if they cultivate a positive corporate culture and are completely consumed and fulfilled by their work. We believe that the most important work of every business leader, regardless of the industry in which they compete, is to emphasize and reinforce these cultural behaviors. And the business leader should vehemently represent this culture like the Catholic tailor described in Warren Buffett’s parable. In the end, the essence of a “culture of character” should be protected at all costs to develop a sustainable business.

What does a cultural nightmare look like in a business? In Berkshire Hathaway’s 2014 Annual Report, which celebrated 50 years of shareholder partnership, Warren Buffett outlined the required characteristics of future Berkshire CEOs. One particular requirement was the CEO’s ability to fight off the "ABCs of business decay"—arrogance, bureaucracy, and complacency. Mr. Buffett stated that once these corporate cancers

metastasize, the strongest of companies can falter. He cited previous "top-of-their-industry" companies that fell victim to these destructive behaviors—General Motors, Sears Roebuck, and U.S. Steel.

How can one recognize the signs of destructive behaviors by top management before they lead to portfolio devastation? We don't have a comprehensive answer or an "early detection system" for identifying the negative ABC attributes identified by Mr. Buffett, and so we attempt to seek positive ABC elements of business ascension—**attention, building, and creation**:

- A CEO that pays rigorous and sincere **attention** to the business—listening to and valuing employees' points of view, caring about the customer, and developing the company's greatest resource—employees (through tailored training)—tends to avoid arrogance.
- When the CEO emphasizes **building** value(s) and character throughout the organization, bureaucracy tends to take a backseat to a higher goal. For example: Ed Catmull, former head of Pixar and Walt Disney Animation Studios, was asked in an interview for *McKinsey Quarterly*: "As you look ahead, what worries you?" His response is interesting and drives home the point about building value and character into an organization:

  > *"Everybody talks about succession planning because of its importance, but to me the issue that's missed is cultural succession. You have to make sure the next level down understands what the actual values are. For example, Walt Disney was driven by technological change and he brought that energy into the company. This was sound and color in the early days of the film industry. Then, in the theme parks, he used the highest technology available to create experiences and animatronics.*
  >
  > *But after he died, the people left didn't fully understand how he thought. So it fell away from the company, and it didn't come back until Walt's nephew, Roy Disney Jr., used his authority to reintroduce the concept. He insisted on getting into a contract with Pixar, over the objection that our software wouldn't save any money. He said, "no, I want it because it will infuse energy into animation." He was very explicit about it—he understood better what Walt was doing.*
  >
  > *The question is, if Walt understood it, why didn't the other people understand it? They just assumed that he was a genius, without thinking about what he was actually doing. Thus, the value wasn't passed on. Today, much of our senior leadership's time is spent making sure our values are deeply embedded at every level of our organization. It is very challenging—but necessary for us to continue making great movies."*

- A CEO's focus on ongoing **creation**—emphasizing the importance of transferring knowledge throughout the organization as well as driving key initiatives that allows the organization to keep its edge—avoids complacency.

In our experience, when arrogance, bureaucracy, and complacency become obvious in one of our invested companies, it is usually too late. We keep a watchful eye on a CEO's display of attention, building, and creation (even when setbacks occur in the business) to maintain our confidence that the organization's "tempo," strategic course for its "players," and cultural "tone" are intact—in other words, that leadership is capably guiding the company's players through a complex but synchronized business symphony.

We can get to the heart of a company's investment opportunity and business leadership by asking two simple questions:

- *Investment:* What do we think we know that others may not know?
- *Business Leadership:* Would we want the CEO to marry into our family?

If answers to these questions are "we are not certain we know anything different from others" and "we would not want this CEO to marry into our family," then we will pass, even if the company is selling at a discount to

its value. It is far better to invest in a business that you have studied and know, and that you believe has something that others may not have recognized. Correspondingly, it is also far better to make a proposal and marry a CEO managing a company that is fairly valued and possesses qualities that you would want to bring into your family rather than hitch your wagon to a leader that has no appreciable value system.

Sustainability and Succession

For a business to survive and thrive over generations, among the most important challenges it will encounter is the test of succession. At present, the average S&P 500 CEO serves for about eight years—which means that in each generation, roughly three CEOs will lead a given large corporation.

Of course, great companies built by long-tenured founders tend to buck this trend, at least currently. Among our large investees are Berkshire Hathaway, where Warren Buffett has served as Chairman since 1970—a term of 51 years and counting; Microsoft, which was led by Bill Gates from its founding in 1975 until stepping down in 2000, a tenure of 25 years; and FedEx, founded in 1971 by Fred Smith, who continues as CEO today, a Buffett-like tenure of a half-century. We also own Disney, led by Walt Disney from its founding in 1923 until his death in 1966, a tenure of 43 years; Facebook, founded by Mark Zuckerberg in 2004 and still led by him 17 years later; and other companies with similar leadership stories.

In each succession case, the CEO faces a difficult decision—one of great consequence to the organization. It is not a matter of focusing just on intelligence, experience, or even capabilities. Taking responsibility for an organization is not the same as running a division—once you're the boss, the entire organization is watching you for their cues.

When a company faces a succession challenge, so too does its investors. Making this decision correctly can be crucial to the investment outcome—for example, those who misjudged Jeffrey Immelt as a capable leader of General Electric or Tim Cook as an incapable leader for Apple made costly mistakes. It is not always easy to know.

As the front-page saga with General Electric has shown, replacing a legend—in GE's case, it was Jack Welch, the super-CEO of the 1980s–1990s—is no cinch. GE was heralded as *the* management succession machine—its training courses in Crotonville, rotational programs, and leadership development reputation were considered second to none. And yet there is widespread agreement that, with all the talent available to him, Welch almost certainly made the wrong choice. Several CEOs after Welch's departure, and after the company had to be broken apart to survive, GE is only now beginning to be managed to its potential again.

At Founders, the question we ask ourselves when assessing succession choices (and leadership in general) is: Given the circumstances of the organization at this moment in its evolution, does the succeeding CEO have the ability to assume the mantle *using his own strengths and ability*—not by an ability to strictly follow in the footsteps of his predecessor?

Like everything in business, there is an art to this. The business world is extremely dynamic—perhaps more so now than at any time in the past. The CEO of any business—from a local restaurant up to the largest multinational—cannot rest on the accomplishments of earlier generations—the business world will gladly move on without you. Like a great band trying to write a follow-up to its smash-hit debut, any new CEO must balance two competing ideals: Maintaining what made the company great in the first place while continuing to shape and adapt it to an ever-changing world.

It's not always easy. Suppose you're named CEO of a company with a dominant software franchise that may undergo threats from a new software ecosystem. Do you play the game in a way that will defend the old franchise, or do you slowly leave the old ways behind as you find new ways of operating in a changing business environment? If the latter: How fast should you move, and how much should you risk?

Microsoft faced this exact dilemma. Arguably, the two CEOs that succeeded Bill Gates made different decisions, and only the current CEO has reaped great success. Intel Corp, another Founders portfolio holding, faced similar succession-related choices as the CEO-ship moved farther and farther away from the executives

who had been part of its successes in the 1980s and 1990s under the "Wintel monopoly" (i.e., Windows PCs running on Intel chips).

Successor CEOs must have the strength of character and the leadership ability to face such issues head on. Perhaps what gets our attention most in these cases are successors who believe they must operate in the mold of their predecessors—as if the next CEO of Berkshire Hathaway could possibly imitate Warren Buffett, or new Amazon CEO Andy Jassey could possibly imitate Jeff Bezos, or Tim Cook of Apple could have possibly imitated Steve Jobs (fortunately, he did not try). No two human beings are alike, and businesses need different things at different points in their progression over time—imitation is useless.

Having watched many failed transitions like the one at GE, we have also witnessed the power of a successful transition—the result of making the right choice. Let's take the example of Disney.

When the legendary Disney executive Michael Eisner lost his business partner—his business *spouse*, as he referred to him, Frank Wells—in 1994, Disney slowly began to enter a period of struggle. Disney Animation lacked any recognizable hits, the theme parks were seen as stagnant and wasteful, acquisitions were not working, and the very high stock price floundered. Eisner tried to find a replacement for Wells, naming—among others—the Hollywood agent Michael Ovitz, an inappropriate figure who lasted only a year. By 2003, with pressure from the board, Eisner was ready to step down. Who would succeed the greatest Disney CEO since Disney himself?

The board was not convinced that Eisner's choice—COO Bob Iger—was the correct choice. Iger, however, was prepared to lead following his experience at Cap Cities/ABC (which was acquired by Disney), where he had been trained by accomplished business legends Tom Murphy and Dan Burke, who became his role models for good management. Iger did not seek to imitate Eisner or, seemingly, anyone else—he had his own plan in mind.

Iger's success surpassed that of Eisner. By repairing Disney's checkered relationship with Pixar (which was owned by Steve Jobs), Iger was able to add not only Pixar's movies, but its genius leaders—Ed Catmull and John Lasseter—to the Disney fold, who then rejuvenated the struggling Disney Animation division. Next, Iger added Marvel Studios and, later, Lucasfilm, in an effort to bulk up Disney's branded content portfolio—in the process, rejuvenating the health and consumer relevance of each of those brands. Never resting, Iger finished his career at Disney by purchasing the content library of assets at Fox and pushing for Disney to transform its business into a direct-to-consumer powerhouse with the introduction of Disney+ and ESPN+ subscription video-on-demand streaming services. Along with Netflix, Disney is now a direct-to-consumer leader and remains the 10-ton elephant of the film industry with its Marvel, Star Wars, and Disney/Pixar hydra. For all his struggles during the latter part of his Disney tenure, Michael Eisner's final stroke as CEO—naming Bob Iger—turned out to be genius. It's hard to imagine any other choice succeeding as well.

This is why we watch succession issues with a close eye, looking for the unusual man or woman with the ability to manage and lead in a style that is uniquely their own. Successors must look to the future, not backward, managing the company in a way that maintains the attributes that made it great while pushing it in directions unforeseen by their predecessors. We keep an extra sharp eye on transitioning businesses with successor CEOs and teams in which we have not been able to develop an acceptable level of confidence. The risks—and rewards—of the succession process demand no less.

* * *

At Founders, we care deeply about the trust required for clients to commit money to our stewardship. We view our clients as our partners and our investment activity for clients is indistinguishable from how we invest our own money—in other words, we eat our own cooking. Founders' market behavior will remain simple: We hold on tightly to our value investing philosophy, and we seek to invest in sustainable and secure businesses that have what it takes to increase intrinsic value over the long term. 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 the market's short-term movements, avoiding the influence of emotional reactions to fluctuations. Instead, we will keep our eyes open for opportunities that emerge in an uncertain environment—and thus, we will continue to exercise patience. Given the increasingly speculative market behavior taking place in recent times, 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 forgo buying shares in an outstanding business whose long-term future is predictable, because of short-term worries about an economy or a stock market that we know to be unpredictable. Why scrap an informed decision because of an uninformed guess?"**
>
> ***–Warren Buffett***

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Equity Holdings: 2021 Highlights

The intrinsic value of our aggregate equity holdings held steady during 2021, despite the ongoing pandemic. We remain positive about our capital allocations, including expected returns over the next 10 years—despite any short-term economic and political challenges that surfaced this past year and that will likely continue into 2022.

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 building sustainable and secure businesses that increase 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 businesses that fall into the "valuable" and "invaluable" categories and that their increasing intrinsic business value will be realized over time.**
- **Our invested companies have 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—PepsiCo, CSX, Federal Express, Alphabet (Google), Meta Platforms (Facebook), Microsoft, Intel, Berkshire Hathaway, Wells Fargo, American Express, CarMax, Home Depot, 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 2021, along with our expectations for 2022.

CONSUMER GROUP

Although consumer-related businesses will continue to face challenging economic and competitive conditions in the upcoming year with the ongoing pandemic, we are pleased with the resilient performance of our Consumer Group in 2021 and expect to see positive results continue during 2022 as the economy continues to recover and society fully reopens.

PepsiCo

Our primary consumer holding—PepsiCo—was successful in growing its global franchise during another challenging year of the pandemic. Reported revenues and operating profits for PepsiCo increased approximately 11% in 2021 as consumers continued to favor PepsiCo's beverage and snack food products during the pandemic—attendance at sporting events and restaurants resumed this past year, and most movie theaters and tourist attractions reopened—all of which impacted beverage and snack food purchases. The future of PepsiCo remains bright as this core consumer goods company continues to cultivate its presence in both developed and emerging global markets.

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

1. An estimated $850 billion of non-alcohol beverages were served around the globe in 2021, and this market is expected to grow to $1.2 trillion by 2027. Although PepsiCo's beverage products sold worldwide represent a large portion of the market, there's a lot more market share to grab. It is our opinion that PepsiCo can become much larger in the future as large emerging markets such as China and India continue to develop their middle class.

2. PepsiCo owns 23 brands that generate more than $1 billion a year in sales and has operations around the world. In 2022, PepsiCo's products will be distributed across more than 200 countries and are projected to generate annual net revenues of more than $80 billion. PepsiCo's beverage products encompass well-known brands such as flagship Pepsi, Gatorade, Aquafina, and ready-to-drink tea and coffee drinks. If the world desires a new type of drink (such as health-conscious beverages), it is likely that PepsiCo will produce and distribute it—in many varieties. In addition, PepsiCo is also the largest snack-food company in the world, with a global product offering that exceeds its beverage counterpart.

PepsiCo is a sustainable and secure business and has earned a place in our "extremely valuable" business category—enterprises that can grow far into the future and stand the test of time. PepsiCo's 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 of PepsiCo's business segments—beverages and snack foods—will substantially penetrate developing markets over the next 25 years, and the accumulated potential growth of these businesses cannot be fully identified using traditional valuation models—in other words, PepsiCo's business holds superior intrinsic value, underscored by the company's long-term value-creation potential.

2021 was a banner year for PepsiCo; consumer demand continued to recover as pandemic quarantine restrictions on restaurants and sporting events were lifted. In addition, while the pandemic significantly impacted outdoor consumption the past eighteen months, it also resulted in an increased in-home consumption rate that positively impacted PepsiCo's revenue. PepsiCo grew revenues 4.8% in 2020 and another 11.5% in 2021. Despite PepsiCo's year-over-year revenue growth in 2020, net income decreased 1.1% in 2020 due to cost increases resulting from the pandemic. During 2021, PepsiCo's net income rebounded approximately 11.1%, and we expect 2022 revenue and net income to increase 4% and 7% respectively.

PepsiCo continued to increase its returns to shareholders, raising the annual dividend by 5% in 2021, from $4.09 per share to $4.20 per share. We expect PepsiCo to raise its dividend in 2022 to approximately $4.40 per share, which implies an approximate forward dividend yield of 2.52% at the year-end stock price. In addition, we anticipate that the company will repurchase $2.3 billion of stock during the next 12 months. This action would add another 1% return to shareholders, representing a 3.52% forward pass-through yield.

In summary, PepsiCo continues to prove resilient to downturns and market system deterrents. We like the long-term potential and economics of the beverage and snacks business and think this industry holds a multi-decade growth opportunity for dominant companies. PepsiCo has a large and growing position in these business segments and will remain a long-term holding in our portfolio.

TRANSPORTATION GROUP

Our primary transportation holdings—CSX Railroad and Federal Express—are unique businesses that we believe will grow as economies develop around the globe. These businesses are capital-intensive and sensitive to economic cycles, however, which subjects them to setbacks when tougher economic conditions emerge from time to time. We remain sanguine about future global economic growth and believe that these businesses will gain further traction in upcoming years. Future growth in the European and Asian economies, augmented by U.S. infrastructure investment, should allow these businesses to make further advances over the next decade.

Our transportation group is composed mostly of highly networked, infrastructure-related businesses focused on transportation efficiency and product innovation. Each of these infrastructure businesses offers high-end

products and/or services that are extremely expensive to produce and/or duplicate—attributes that normally would be detrimental to a business' profitability. These special businesses possess "networking effects" that allow profitability to grow faster than revenue over time, however, due to expanded customer usage occurring over fixed-cost investments. This tends to result in oligopolies, with two or three competitors dominating an industry. As globalization continues, the consolidation of businesses involved in transporting purchased goods is a natural development, with fewer companies positioned to provide the breadth of products and services customer's demand. Thus, the long-term trend is for these transportation companies to become ever more entrenched, expanding their competitive advantages—and profitability.

Our transportation investments in CSX and FedEx have 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—another Founders holding). This holds true in the air freight and overnight package business as well—FedEx and UPS have spent decades building out their air and ground infrastructures, and it would take enormous time and capital to create a transportation system to compete with these entities. Although transportation businesses are 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 to minimize costs. Moving greater amounts of goods over fixed-rail, -air, and -ground infrastructures instead of via higher-cost alternatives such as traditional trucking enables companies to lower costs and achieve large productivity gains. For example, rail transportation is three to five times more fuel-efficient than truck transportation, and it is likely that railroads will play a larger role in the efficient transportation of goods throughout the U.S. in the future.

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 19,500 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 3,500 locomotives and more than 67,000 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.

As you may recall from last year's letter, CSX expanded its network by announcing an agreement to acquire New England's Pan Am Railways, whose rail carrier subsidiaries constitute North America's largest regional railroad. Pan Am Railways operates a highly integrated, nearly 1,200-mile network and has a partial interest in the more than 600-mile Pan Am Southern system. Pan Am's network across New England provides CSX further access to multiple ports and large-scale commodity producers. With this addition, CSX gains a strong regional network in one of the most densely populated markets in the U.S., creating new efficiencies and market opportunities for customers as the company continues to grow. During 2021, CSX began the process of seeking approval for the Pan Am acquisition from the Surface Transportation Board—the U.S. regulatory agency charged with overseeing railroads and other modes of surface transportation—and a decision is expected by April 1, 2022. Although this acquisition has yet to completed, we remain excited about this potential addition and look forward to the positive results of Pan Am's and CSX's integrated network.

On July 1, 2021, CSX completed its acquisition of Quality Carriers, the largest provider of bulk liquid chemicals truck transportation in North America, for $546 million in cash. Quality Carriers has a network of more than 100 company-owned and affiliate terminals and facilities in key locations throughout the U.S., Canada, and Mexico. The Quality Carrier purchase provides CSX an opportunity to expand transportation services to many of the leading chemical producers and shippers in North America.

In 2021, CSX generated approximately $12.5 billion in revenue—17% greater than in 2020, while profits increased over 31%, to nearly $3.6 billion. CSX's revenue and profits have fully recovered from the economic slowdown caused by the pandemic. The company continues to execute on its new operating model—precision-scheduled railroading—focused on developing and strictly maintaining a scheduled service plan in a way that optimizes railway assets. CSX has been applying this innovative new operating model successfully over the past few years, improving its customer service, lowering costs, and increasing free cash flow. We expect further efficiencies to emerge at CSX as the economy fully recovers and the U.S. infrastructure spending plan is executed. Given CSX's continuing profit growth over the past five years, we believe this positive trend will continue and remain very optimistic about our ownership position in this one-of-a-kind railroad.

During 2021, CSX distributed approximately $3.4 billion of cash to shareholders in the form of dividends (around $840 million) and share repurchases (another $$2.55 billion). In 2022, we anticipate that CSX per-share earnings will grow by 15% as the U.S. economy recovers and the railroad continues to execute on precision-scheduled railroading. We expect CSX to distribute an additional $3.5 billion to shareholders through a combined dividend and stock repurchase program. This provides shareholders an approximate 4.2% 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 will likely accelerate over the next five years as a result of the impending U.S. infrastructure program investment. We believe that the growth in CSX's freight volume will endure over the upcoming decade and may increase more than many investment 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 continue to leverage CSX's income and cash available for shareholders. We remain long-term owners of CSX, which occupies an important position in our portfolio.

FedEx Corp.

Since the latter part of 2018, we have been accumulating a position in FedEx Corp. We happened to begin buying FedEx just prior to the U.S. 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 due to trade skirmishes between the two countries. But after this initial decline, a significant offset occurred when the pandemic hit in 2020, forcing people to stay home, shop online, and have their goods delivered—and catapulted FedEx's revenues and profits.

We remain extremely positive about our long-term investment in FedEx and believe that the shipment and delivery of goods throughout the world will continue to grow. Greater customer use on this company's fixed network will improve profitability and returns on capital in the future, adding value to FedEx and shareholders.

Some background on this company: 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 through 650 airports, 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, along with certain back-office functions that support its 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 the company's 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 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 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. FedEx is rolling out same-day and autonomous special delivery systems that are positioned to lead the industry in logistics efficiency.
- **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 all shipping needs of high-tech and high-value-added industries.
- **Reducing environmental impact:** FedEx established an initiative to have a net-zero carbon footprint by 2040, mainly by converting its vast parcel pickup and delivery fleet to electric.

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 uniquely 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.

FedEx Corp. is expected to earn $5.5 billion of net income in its fiscal year ending May, 2022, or an adjusted $20.50 per share—a 12.9% year-over-year increase from May, 2021. We expect combined per-share earnings to increase approximately 12% in fiscal 2023, to $22.95 per share. When comparing forward earnings to the company's year-end stock price of $259 per share, investors are receiving an entry earnings yield of 8.8% 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.

TECHNOLOGY & COMMUNICATION GROUP

Each year, we begin this section by highlighting the investment opportunity potential of the information technology and communication 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 2021, the technology and communication sector once again experienced change at breakneck speed as device miniaturization continued, cloud computing thrived, social media interaction and e-tailing flourished, and technology advancements enabled further adoption of artificial intelligence (AI) in varied market sectors.

The inherent disruption and warp-speed change of the technology and communication sector continue to make it extremely difficult to determine which companies will succeed or fail. Around 14.5 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 market-share-hungry competitors developing "copycat" Apple products. Although Apple continues to be a leading technological innovator, disruption has taken hold as additional innovative devices enter consumer and commercial markets. In addition, exponential growth in cloud-based services continues in both 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, shop, 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 technology companies that rely primarily on sales of previously popular hardware devices such as PCs.

Which companies gain competitive control in the evolving technology and communication 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 and communication companies that we believe occupy a strong competitive position in the evolving landscape—and have the ability to survive in the future. Even with this objective, we are unable to point to a single specific company in this industry that could be placed in the "guaranteed invaluable business basket"—so much ongoing disruption makes it impossible to call.

Therefore, we are invested in what we believe to be technology and communication companies that provide core products that all individual and commercial customers need. Our large technology and communication holdings include Microsoft, Intel, Alphabet (Google), and Meta Platforms (Facebook).

Microsoft

Microsoft exemplifies the uncertainty inherent in investing in technology companies. Although Microsoft has been a business success since its public debut in 1986, the past 36 years have hardly been easy for this technology titan that faced trying times with competition, the U.S. government, and a rapidly changing technology landscape. Nine years ago, Microsoft was written off as a dinosaur as the company struggled with its primary product—Windows—in a dramatically changing technology landscape in which consumers were quickly moving toward companies that offered full hardware and software integration across all their devices (like Apple products). In response to this development, Microsoft decided to radically alter its strategy to become "more like Apple." To accomplish an integrated product strategy, Microsoft began to make proprietary devices for consumers such as phones and tablets that integrated Microsoft software. The company also decided to purchase 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 shift to a consumer-centric business model turned

out to be ill-conceived, and the company's business and leadership stumbled badly, leading many investors to question the company's ability to survive.

Just as Microsoft's ill-adapted business model seemed to threaten the company's viability, the company's board of directors, influenced by Bill Gates, decided to make a crucial management change. In early 2014, Microsoft's board 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 shifting its primary focus away from Windows and devices and emerging as a leader in providing enterprise applications and cloud-based services to small, medium-size, and large businesses.

The emergence of cloud computing—the delivery of computing as a service instead of as a product—has vastly changed the technology landscape since its introduction in 2006. 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 for 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, 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 business segment is very attractive, as well as potentially very profitable, due to its "tech tentacles" and long-term annuity-like attributes. Large organizations 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 uses such as vision, speech, and text as well as facial and emotion detection. Microsoft's market share of the cloud infrastructure business jumped from 10% in 2017 to 21% in 2021. Although Amazon Web Services (AWS) maintained a leading 32% share of the cloud infrastructure market this past year, the cloud computing business is still in the early innings, and Microsoft continues to gain ground. We believe that the future presents unlimited potential for Microsoft and that Mr. Nadella is committed to staying at the forefront of this technology revolution.

Microsoft had another year of sensational business results in 2021, and we are enthusiastic about the company's prospects in 2022. Microsoft's adjusted earnings are expected to be approximately $9.33 per share in its fiscal year-end June, 2022, putting the company on pace to reach per-share earnings exceeding $10.50 by its fiscal year-end 2023. During the fiscal year, Microsoft will generate approximately $64 billion of owner earnings and will return a large amount of this cash to shareholders through net share repurchases of approximately $33 billion and around $17 billion of dividends (an approximate 2% pass-through yield at the year-end stock price). With its consistent return of cash to owners and growing position in the technology industry, Microsoft will remain a long-term position in our portfolio.

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 maintains a dominant market share in many of its product categories. Despite this dominance, technology disruption continues to impact 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 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.

Another disruption confronting Intel is the revolutionary change that has occurred in semiconductor chip manufacturing. In the past, semiconductor companies integrated proprietary-designed semiconductor chips and manufacturing (or fabrication). For decades, Intel led integrated semiconductor chip design and fabrication, which provided the company a competitive advantage in its industry. Intel controlled product cadence by introducing the next generation of semiconductor chips every two or so years through Moore's Law (named for Gordon Moore, a co-founder of Intel who authored the principle that propelled the digital revolution—the prediction that the number of transistors that would fit on a microchip would double every two years, with the cost of computing halved). Adhering to Moore's Law, Intel would focus on research and design and would fabricate a new chip just when competitors were able to match and fabricate Intel's previous model. This one-step-ahead approach allowed Intel to lower the price of its previous semiconductor chip just when competitors were introducing their equivalent versions to the marketplace (hurting competitors ability to make money). Simultaneously, Intel would introduce a superior-functioning semiconductor chip at a higher price—maximizing its profitability and market share of higher-performing "next-generation" semiconductor chips as other industry participants struggled to keep up.

Of course, every strength can eventually lead to a weakness. Over the past several years, Intel competitors decided to focus only on research and design of semiconductor chips while outsourcing manufacturing to other fabrication companies. Taiwan Semiconductor is now the largest chip fabrication company in the world, manufacturing more than 90% of advanced processors (high-design chips) for fabless semiconductor companies such as Advanced Micro Devices, Apple, Broadcom, Marvell, Nvidia, and Qualcomm. This fabrication disruption has allowed Intel's competitors to become very nimble. This change, combined with a slowdown in Moore's Law—it now takes more than two years for the power of computing to double—created a newly competitive environment that presented immediate challenges for Intel's integrated business model.

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 is embarking on a focused strategy to solidify its position in a new era in which computing is interconnected and distributed across a variety of platforms. The company is transitioning from a PC-centric organization to a data-centric one and expanding its product offerings to seize new market opportunities.

Intel remains focused on the following areas:

- Accelerating growth, especially in the data-centric market, which is expected to reach $230 billion by 2024
- Establishing complete customer focus and improving execution to deliver technology leadership
- Deploying capital effectively to maximize growth and shareholder returns
- Evolving Intel's employee culture to maintain a competitive edge

Intel's emphasis on these areas is driving the company to develop product solutions that will maximize the customer experience.

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 4,874 co-located data centers in 129 countries (around 38% located in the U.S.) make up the "global computing platform." These data centers collectively contain more than 100 million interconnected computer servers, most of which are running on Intel products.

As part of Intel's efforts to maximize returns for shareholders, the company recently announced its intention to take Mobileye public in mid-2022 via an IPO of newly issued Mobileye stock. Mobileye is a leading global provider of advanced driver-assistance systems (ADAS) and self-driving solutions. This IPO will unlock the value of Mobileye for Intel shareholders by creating a separately traded company and will build on Mobileye's successful track record of serving an expanding driverless automobile market. Intel will remain the majority owner of Mobileye, and the two companies will continue to collaborate on projects that pursue the growth of computing in the automotive sector. This ongoing partnership is important to Intel shareholders since semiconductors are expected to constitute 20% of the premium vehicle's total bill-of-materials by 2030.

In summary, Intel is managing the current technology disruption, 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 computerization of both high-end and low-end systems, devices, and products.

Intel's revenue declined approximately 5.7% in 2021 vs. 2020, to approximately $73.5 billion. Adjusted earnings also decreased 4.4%, to $4.76 per share this past year, as the company experienced moderate declines in product sales. In last year's letter, we stated that Intel would face headwinds during 2021 as the company adjusted its business model in a changing semiconductor industry. This occurred, and we expect further challenges during 2022 as Intel continues to alter its business and company culture. In the upcoming year, we expect Intel to generate approximately $14.6 billion of earnings and return cash to shareholders through dividends of $5.6 billion—Intel's dividend yield is approximately 2.7% at the year-end stock price. We will be watching Intel closely as it adjusts to the evolving semiconductor marketplace. We still consider Intel a well-positioned technology company with a bright future, and a good investment at its current price.

Alphabet (Google)

Since 2017, we have made a large investment in Alphabet (Google) and have continued to add to this position whenever conditions are advantageous. Our original allocation to Alphabet was a transition from our investment in IBM's leading artificial intelligence (AI) computing technology—after realizing we were on the wrong AI horse; we made a change to Alphabet. We are obviously pleased that we made this adjustment and will maintain a significant position in Alphabet (Google), which we consider to be a long-term strategic holding in our portfolio.

We have stated that the technology industry landscape has changed dramatically over the past seven years, enabling the emergence and application of artificial intelligence (AI). With the rise in cloud computing, massive amounts of data are housed on interconnected computers around the world, and companies seek to transform this information into useful knowledge through the implementation of various applications and data analytics capabilities. Cloud data warehousing (e.g., Snowflake) provide companies an opportunity to combine data from various cloud providers, while "edge computing" and "fog computing" allow 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—a form of utility computing whereby the cloud supplier owns the servers, and pricing is based on the actual number 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 programmers'

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, along with cloud data warehousing, are especially robust in the enterprise and hybrid computing environments, where massive amounts of crucial government and corporate information are 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 has been making major acquisitions and investing in the cloud space to compete for this growing market. This industry space will continue to be a large contributor to future growth, and Google Cloud services provides an avenue for the seamless delivery of Alphabet's other products and services to customers.

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, the Google Chrome web browser, and Chrome OS, a lightweight operating system based on the Chrome browser that has a large share of the U.S. K–12 classroom laptops and tablets market.

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 useful 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 ability to gather information continuously allows Google to learn and 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 adds products and services in the future.

Alphabet acquired or developed a number of software and hardware products during 2021; among the most noteworthy:

- Acquisition of Fitbit, the fitness-tracking device manufacturer, to gather health and wellness information right from the source.

- Development of Google Lens—"smart," AI-driven image recognition technology that enables consumers to search, gather information, and shop online simply by directing a phone's camera at an image or object.
- Alphabet released its Pixel 6 phone this year to high praise. The Pixel 6 is Alphabet's highest-rated smart phone to date. Compiled with Alphabet's prominent AI, the Google Pixel is considered a top iPhone rival and is bridging the gap in the smart phone industry.

Alphabet is an extremely profitable company that produced adjusted earnings of $77 billion in 2021, or $117 per share. Alphabet had a knockout year, with earnings more than doubling the past 12 months! In 2022, Alphabet is expected to grow its per-share earnings to $125.00 and produce owner earnings of approximately $80 billion. This will add to the $140+ billion cash hoard on Alphabet's balance sheet, along with $28 billion of debt. With Alphabet's total market capitalization of approximately $1.9 trillion, and removing net cash after debt cash of approximately $114 billion, a buyer of Google is obtaining an approximate 4.5% forward owner-earnings yield that is growing at approximately 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.

Meta Platforms (Facebook)

The newest large investment in the Founders portfolio is Meta Platforms, née Facebook. Along with Google, Meta is the behemoth of the digital advertising market, on pace to generate $118 billion in revenue in 2021, up an eye-popping 37% from 2020—itself a banner year, with revenue growth of 22% over 2019. Accompanying this high growth are pre-tax profit margins between 35%–40% (depending on the year) and a high level of free cash flow even after accounting for Meta's huge spending to build out its data centers worldwide.

A few other statistics: Every day, roughly 2.8 billion people access one of Meta's products—Facebook, Instagram, and WhatsApp—while another 770 million log in at least once per month, for a total user base of 3.6 billion. Let's run the math on that. The current worldwide population is approximately 7.9 billion at last count. Let's estimate that about one billion are too young to use Meta's products. (Some are probably too old, but we'll leave them in.) Another 1.4 billion live in China, where Meta's products are banned. Without going any further, this means that, of the 5.5 billion people in the world who could be using Meta's products, about 2/3 do so. Words like "powerhouse," "ubiquitous," and "dominant" come to mind here. Only products like Coca-Cola and Google offerings enjoy similar worldwide usage.

Despite its status as a high-growth, high-margin, high-cash-flow duopoly global powerhouse – Meta owns well over half the global digital advertising market in tandem with Alphabet (Google) – Meta is currently somewhat unloved as an investment. The S&P 500 index trades for around 20x 2022 expected earnings, depending on your estimate. With projected earnings of over $14 per share in 2022, Meta trades at a very similar valuation multiple today, including the extra cash sitting on its balance sheet.

In other words, even though Meta is a far-above-average company when measured against every business metric imaginable, investors are not willing to pay a dollar more for its fast, growing earnings than what they will pay for the composite of all major U.S. companies. What explains the disparity?

There are a few explanations. One is that Meta is under regulatory scrutiny. Business observers are very familiar with the congressional investigations, the *Wall Street Journal* reports, and the social media twittering about Meta's platforms on an almost-constant basis. It is possible that the U.S. government will take action to restrict Meta's activities in the future.

However, Meta occupies a unique position of scale in the media ecosystem that the government (and Meta's competitors) would be hard-pressed to replace. Every day, an army of more than 15,000 content moderators, working in tandem with highly refined artificial intelligence servers, moderate the text, video, links, updates, photos, and file uploads of nearly half the world's adult population—an ambitious task, we think. While its failures are at times criticized (fairly), we ask ourselves: If not Meta, who will take on this task? Who else has

the scale, the experience, even the desire to do the job? Mass online social sharing is here to stay, the only question is how it will be managed.

Meta is also heavily criticized for its censorship—the opposite complaint of those who believe the company doesn't censor *enough*. In truth, what most people would like to see are the thoughts of those they disagree with censored while their own voices freely heard. It is a tough balance for any company, let alone one serving dozens of cultures around the world, all with different ideas of what the “proper” level of censorship should be.

We think Meta cares deeply about content moderation and is a victim of its own success—its ubiquity is so overwhelming, and its products so reflective of human proclivities, that problems are inevitable. But Meta is the only company with the scale, skill, desire, and technical talent to handle the problem, and so we believe that its competitive position is here to stay for some time.

The other challenge for Meta is competition. Apps like Snapchat, TikTok, and YouTube, along with others that may come along in future years, are looking to breathe the same oxygen that Meta enjoys so much. Competitors face a steep uphill battle, though. Over the years, Meta has continually pushed to improve its position, introducing Instagram Stories, Instagram Shops (still very early in its lifecycle), Facebook Marketplace, Facebook Shops, Facebook Workplace, and a long list of other products designed to entrench and enhance its usability for consumers. With the amount of data Meta collects daily on user activity, the company has a massive leg up in the development of new products to serve those users.

Meta’s announcement in 2021 of its ambition to help build out the "metaverse" through its Oculus subsidiary proves the point. Meta is not content to dominate digital advertising through its current social media apps: Mr. Zuckerberg and his team believe that Meta must invent the next social platform by creating an online social world that users will occupy in their spare time and, increasingly, in their not-spare time. Regardless of whether this “metaverse” virtual reality effort succeeds as mightily as the company hopes, the move demonstrates that Meta is not resting on its dominant position—like Microsoft many years ago, Meta realizes—correctly—that the company must be “insecure at the top” to maintain the dominant market position. In our experience, this attitude has produced good outcomes over time; conversely, businesses that conduct themselves as if their dominance is assured indefinitely tend to be the ones that struggle to maintain that position. Meta's current management team clearly has no such illusions, and we believe the company will both create and adapt as the online social world evolves.

In the meantime, the core powerhouse of Meta remains its digital advertising platform, which continues to grow at greater than 15% per year, a rate which should continue for several years before it begins to moderate but not cease. Like Coca-Cola, Meta is much more profitable on a per-user basis in the U.S. and Western Europe than in the rest of the world—a disparity that may close over time and represents a very long-term growth opportunity for the business, all metaverses aside. We are excited by this new investment and believe that it provides one of the better investment opportunities currently available in large, liquid public companies.

FINANCIAL SERVICES GROUP

Berkshire Hathaway

Coming off a difficult 2020 for all businesses, Berkshire Hathaway had an admirable 2021. Given Berkshire’s size, it cannot be a fast-growing business any longer—but offsetting that is Berkshire’s unmatched diversity, strength, and predictable growth.

Warren Buffett’s holding company has massive operations in insurance (including Berkshire Hathaway Reinsurance, GEICO, National Indemnity, and General Reinsurance), railroads (the BNSF system), heavy industry (Precision Castparts), utilities (Berkshire Hathaway Energy), food (Kraft Heinz), portfolio management (a $300+ billion equity portfolio, almost 50% of which is Apple stock), and dozens of smaller services and industrial businesses that together make up another large chunk of Berkshire’s value. Berkshire’s total assets are valued at nearly $920 billion, and the company holds more than $480 billion of shareholders’ equity—the largest for any publicly traded corporation in the world, and up 6% since the end of last year.

Berkshire's performance is even more impressive when you realize that its book value *per share* is up much more than that due to its ongoing share repurchase program. At year end, Berkshire is likely to report its book value *per share* is up at least 12% on the year. This would give the company a 5-year record of over 13% annual growth in per-share book value—a tremendous accomplishment considering not only Berkshire's mammoth size, but amid the continuing trend of conglomerate structures (such as General Electric and United Technologies) breaking apart. Berkshire is truly in a class of its own.

In the last four quarters, Berkshire was able to repurchase almost 5% of its outstanding shares—and almost 10% of the pre-buyback total since the repurchase program began in 2019. Stated differently: For every share of Berkshire that we own, we now own an 11% greater share of Berkshire's earnings than we would have otherwise. This is attractive math—especially given the relative difficulty of investing Berkshire's billions in an environment where nearly all other assets of interest to Berkshire are expensive to acquire. We think Mr. Buffett is pursuing a wise policy of enhancing shareholders' interest in owning this wonderful company rather than overpaying for assets in a highly inflated, competitive investment ecosystem.

As it stands today, Berkshire is probably capable of growing between 3%–4% per year from the growth of its underlying business, while share repurchases and/or any future acquisitions should add at least another 5% per year—for a total return of 8%–9% per year over the long term, holding constant the company's valuation relative to book value. While that is our "best guess" given available facts, we continually update our understanding of the company's position as new information comes to light.

One salient fact about Berkshire is that, at present, the company has roughly $150 billion in cash and cash equivalents on its balance sheet—almost 22% of its total market capitalization—which currently earns a paltry return: Less than 1% per year. The difference between that sub-1% return and, say, a 5% return is worth at least $7 billion *per year* to Berkshire—or $3/share in earnings and perhaps $45/share in current intrinsic value on the "B" shares. This leaves a lot of room for earnings growth as interest rates rise and a more accommodating environment allows Berkshire to put some of its cash pile to work at better returns.

Berkshire also took a big step this year by formally announcing Mr. Buffett's successor as CEO: Greg Abel, the current Vice Chairman of Non-Insurance Operations and former CEO of Berkshire Hathaway Energy. Over a 30-year period at BHE (formerly Mid-American Energy), Mr. Abel has demonstrated that he is a very talented business operator who can also allocate capital and manage a conglomerate-style business. Joining forces with Ajit Jain, the Chairman of Berkshire Hathaway's Insurance companies, and the two investment managers appointed by Mr. Buffett, Berkshire is in capable hands. Mr. Buffett and his partner, Mr. Munger, are—of course—irreplaceable, but the next generation will bring a more youthful perspective, intelligence, and energy to the job that the two genius founders have not been able to apply due simply to age.

Altogether, Berkshire remains a fairly-valued investment growing at an above-average rate (on a per-share basis) and has the lowest chance of *permanent* loss among any assets we currently own or can contemplate owning in today's market.

Wells Fargo

2021 was a quiet year for our banking position, Wells Fargo. As discussed in our 2020 Annual Report (available on request), the main issue Wells confronts is the continued compression of interest rate spreads (net interest margin, or NIM), the all-important butter on the bread of bank shareholders. As we predicted, 2021 was even worse than 2020 on this measure—Wells' net interest margin in the first nine months was a mere 2.03%, compared to 2.32% (and greater than 4% in its best years).

To appreciate the effect of the NIM compression, consider that the difference between a 2.0% and 2.5% margin on Wells Fargo's $1.77T in interest-earning assets is almost $9 billion per year pre-tax—all of which would be incremental profit to the company after paying taxes. At a tax rate of 25% and 4.1 billion shares outstanding, Wells is giving up $1.60 per share of earnings simply due to interest rate compression—against

current earnings of around $4/share. It's not hard to imagine how the math works out if one assumes a 3% or greater NIM, historically well within the reasonable range.

Wells also has to, of course, finish dealing with the regulatory challenges we articulated in last year's letter. Progress has been slower than we'd hoped on this front, delayed in part by COVID and in part by the inability of management to get Wells Fargo's systems and processes up to date and in acceptable shape for regulators to feel comfortable that its past transgressions won't be repeated. The company's CFO stated in the latter part of 2021 that it may be a few more years before regulators let up and allow Wells to grow again, which demonstrates how harshly they have come down on the bank's activities.

Nevertheless, we remain patient during Wells' challenges. The core metrics that create bank profitability remain solidly in place at Wells. Its massive deposit franchise continued to grow in 2021, most likely ending the year at $1.5 trillion—up almost 7% from the previous year. Credit quality also remains very high, with losses in 2021 negligible and 2020's COVID-related carnage not producing nearly as much agony as the bank had expected.

In the meantime, while the world is down on the company and its stock, in particular, Wells is rapidly buying back its own shares with the excess capital released by its restricted growth. In late June, the company announced a plan to repurchase $18 billion of stock through mid-2022, equivalent to about 10% of the company's shares in a single year, while raising the dividend. At the same time, Wells continues to close down excess branches (267 in 2021 alone), improve its digital offering, expand its wealth management business, grow its deposit franchise, and prepare for a more favorable operating environment.

Banks like Wells Fargo have huge competitive advantages and very "sticky" customer bases. When Wells began to have trouble roughly 5 years ago, it was predicted that its banking customers would leave it in droves. That hasn't happened. In 2021, deposits, client accounts, and wealth assets under management were all hitting all-time highs for the bank. It turns out that most banking customers are not so inclined to switch their bank! On top of this, in the digital age, only the largest banking enterprises have the resources to manage the regulatory, fraud prevention, and technological changes wrought by the modern world. Small banks are rapidly consolidating just to stay in the game.

The dynamics at play for Wells are clear. Assuming that the company eventually clears up its regulatory challenge and continues to reduce costs (which should be down close to 3% this year, even though the bank's growth was flat), any rebound in its net-interest margin will occur on a much-reduced share count, creating record earnings per share and potentially a much higher stock price than today. As long as these dynamics are in play and the stock price remains flat, we are willing to be patient with Wells' new management as it works through the complex issues it inherited.

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. Although the pandemic severely curtailed travel in 2020, the revitalization of travel and consumer spending in the back half of 2021 produced pre-pandemic levels of revenue that we see growing at a steady clip in the future.

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, that 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 those of 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 greater than 50% of the company's total revenues. American Express may also generate revenue from interest earned on loans that are issued to cardholders, from cardholder membership fees, and from travel services. Unlike the Visa and MasterCard model, the American Express revenue model does not depend on the volume of transactions processed but focuses on the total amount spent by each customer. Thus, American Express employs a "spend-centric" business model, attracting affluent customers who are likely to spend more than average.

The American Express Competitive Advantage

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

Large corporations 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 their travel policies, corporations require employees to charge all 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 large corporation's 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.

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 is unique in this realm 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 card for small and midsize businesses 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. Amex leaves the chase for low-producing, price- and credit-sensitive consumers that are not brand-sensitive to banks that 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). American Express has an ongoing opportunity to cross-sell and increase its share of customer financial transactions through additional cards it issues 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.

During 2021, American Express experienced an approximate 16% increase in revenue, to $41.9 billion, due to travel revenue streams bouncing back after loosened Covid restrictions. The company produced around $7.6 billion of earnings this year, or $9.60 per share—representing an increase of more than 150% from $3.77 per share in 2020 as the company bounced back from last year's pandemic-depressed metrics. The company maintained its dividend, distributing more than $1.4 billion to shareholders during 2021. American Express also ramped up its stock repurchase program, buying back over $5.5 billion of stock during the past 12 months—creating value for long-term shareholders. Overall, in 2021, American Express' business rebounded significantly, especially in the second half of the year. The company's 2021 earnings were in line with pre-pandemic levels, giving us confidence that American Express will resume growing its franchise throughout the world. With American Express' tremendous future in a global marketplace in which cash sales are diminishing, higher-income consumers are increasing in number, and corporate productivity pressures are mounting, we remain enthusiastic owners of this great franchise.

RETAIL GROUP

Our major retail holdings—CarMax and Home Depot—collectively had another year of expansion in 2021, with combined retail sales growing more than 19% at these specialty businesses. We expect continued growth for our retail group in 2022, anticipating an approximate 2% further increase in combined sales. The expanding intrinsic business values of CarMax and Home Depot were once again reflected in their increased stock prices this past year. We plan to remain owners of these great businesses, confident about their growth in intrinsic value as these retail franchises 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 "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 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, JCPenney, and Pier 1 have all gone through bankruptcy, and once-robust retailers like Gap and Bed Bath & Beyond 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—especially during the pandemic. Despite tough competition, these retailers continue to gain ground in their difficult respective retail realms and will likely gain additional ground in upcoming years—perhaps 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

At first glance, CarMax had the year to beat all years—the company is likely to end the year with revenues up more than 50% from 2020 (FY21)! To anyone who tried to buy a car in 2021, the reason for these numbers is clear: A massive pandemic-related disruption in the automotive supply chain made new cars very hard to come by, boosting the value of used cars to unprecedented levels. One widely followed index showed used-car values up almost 70% at the end of 2021 compared to pre-COVID levels at the end of 2019—a "fat tail" event if there ever was one. Looking at 2021 alone, used-car values are about 50% higher compared to 2020. This explains the similar rise in CarMax's revenues.

CarMax made a notable choice in this year of turmoil, one that gives us great confidence as shareholders: The company decided to stick to its discipline and did *not* raise its own markup to customers, which averages about $2,200 per car. In a tough year to buy a car, CarMax demonstrated that they would do everything possible to help the consumer—a move we believed likely engendered goodwill in a competitive marketplace.

Rather than focus on exploiting a disruption in the car market that will prove to be temporary, in 2021, CarMax focused on continuing to build its long-term competitive position. The "omni-channel" program is now complete: By the end of the fiscal year, every CarMax customer coast to coast will have the ability to fully complete their transactions online if they wish. CarMax is now the only used car retailer with a full physical and digital footprint and is positioned to continue growing its share of the large, fragmented used car trade, which sells more than 20 million used (up to 10 years old) cars that are every year.

Consumers are increasingly taking CarMax up on its digital offer: Online revenues in the most recently reported quarter were 28% of the total—and growing quickly. (Just a year earlier the number was 18%.) We expect that five years from now, the solid majority of CarMax's sales will occur in the online channel, and this innovation will be hard for all but a very few competitors to match. Although the thousands of smaller used-car dealerships are indeed able to consolidate and leverage their inventories using online channels such as Autotrader, it's simply not the same experience as getting an instant appraisal for your current car, finding your dream car in perfect condition, arranging financing, and having your new car delivered—all from the comfort of your home, with little effort. CarMax and Carvana are likely to be the two-horse race that pace all of the others.

On the car-buying side of things: CarMax is transitioning rapidly to an online car appraisal system. As of the most recent quarter, CarMax is now buying more cars through its online channel than it is offline, and that trend will continue until the vast majority of car appraisals are done instantly and online—the experience is just so much better than anything else available. While there will always be customers who choose to go it on their own and sell a car privately to cut out the dealer profit, we predict that a large and growing fraction of car buyers will choose the simple option. As that happens, CarMax and Carvana will continue to be the leaders in obtaining inventory directly, rather than through wholesalers.

Even though it prefers to buy directly than from wholesalers, CarMax indeed runs its own large, "captive" (self-owned) used-car wholesale operation for others. Since many of the cars CarMax buys are not up to its standards for sale, CarMax must find an outlet for them, and the most efficient way to do that is by setting up (increasingly online) auctions through which lower-end used car dealers can obtain their inventory and pay CarMax. Since they do not have their own "engines" for acquiring large numbers of cars, these dealers must deal with CarMax and other wholesalers, creating a nice ancillary profit stream for CarMax.

CarMax also is part bank. The financial operation CarMax runs had a terrific year in 2021, with low losses and high growth. CarMax now manages more than $15 billion (and growing) in loans on which they earn, over time, a 3%–4% margin after accounting for any losses—far better than an average banking operation and proven through multiple economic cycles, including the most recent pandemic environment. By originating its own loans and keeping the most creditworthy "cream" off the top for themselves while selling the rest to banking partners, CarMax has managed over many years to keep losses manageable and profits high. The "captive" auto finance portion of CarMax's business is, in general, an underrated and highly important aspect of its business, which should continue to grow as the operation as a whole grows.

As it stands now, CarMax is ambitious. By the end of calendar year 2025—3 years from now—CarMax hopes to be selling two million vehicles through its retail and wholesale channels (a growth of around 10% per year) and grow its national market share from 4.3% to 5% of used cars that are up to 10 years old. This seems easily achievable given the company's current position, and we look forward to writing to you when they achieve it.

CarMax is on pace to earn roughly $7/share of normalized earnings for 2021 and is another regular repurchaser of shares, regularly repurchasing 3%–4% of its shares per year pre-COVID—a figure the company should be able to return to in the near future with the closing of its acquisition of Edmunds—the automotive research and vehicle-listings website—bolstering its profitability. That acquisition, combined with new store growth on CarMax's 220+ unit store base, the growth in its wholesale and captive finance units, and—most important—the growth of its online consumer channel—positions CarMax to continue growing its per-share earnings and per-share intrinsic value at a double-digit rate for many years. With the shares trading at only 14x their most likely earnings in 2022—a meaningful discount to the market for a high-quality and growing business—we remain optimistic shareholders.

Home Depot

It's been another good—surprisingly good—year for Home Depot. While 2020 was, in many ways, the best year in the company's history as it benefited massively from the COVID house-improvement boom, Home Depot didn't rest in 2021. The company is likely to end the year with $150 billion in revenue, a growth of 13%

over 2020's $132 billion, which was itself a massive 20% increase over the prior year. Because this revenue growth happened almost entirely through Home Depot's existing store base of 2,317 stores in the U.S., Canada, and Mexico (the company only opened five stores and acquired another 14 this year), Home Depot's pre-tax profit margins are also increasing, hitting a record high in 2021. All of this is likely to result in another all-time high for Home Depot's earnings of about $15.50 per share, up 30% from 2020.

Home Depot is benefiting from a number of trends in its sector and in the country. Home improvement spending in the U.S. is about $450 billion per year and has increased over time at a steady rate of 4%–5% per year—and this is likely to continue into the future. Home Depot and its competitor, Lowe's, capture an increasing share of this spend through their massive, well-located warehouses in nearly every community of size in the U.S., with the combined two accounting for nearly $230 billion of revenue in the U.S. home improvement sector in 2021, or about 50% of total revenue. It wouldn't surprise us if that share continued to increase as both Home Depot and Lowe's implement contractor-friendly "Pro" programs (discussed in last year's Annual Report) that seek to grab share from smaller independent players across the country in categories such as lumber, tools, paint, and dozens of other products contractors and homeowners need daily to keep our homes and buildings in shape.

Home Depot's competitive advantages run deep. The company has purchasing scale that cannot be matched in all key home improvement categories—hundreds of thousands of contractors and millions of do-it-yourselfers habitually visit Home Depots every year, and the company has large physical footprints (both its retail locations and its massive central distribution warehouses) that distribute lots of large, heavy, and "needed-on-demand" types of products that are not easily distributed by aggressive general merchandise e-tailers like Amazon. Where else can one obtain 10 gallons of paint, a pile of 2x4s, a miter saw, a light fixture, and a candy bar in one place, at a fair price, and with guidance from an expert?

We predict a long and bright future for Home Depot, but with some reservations, of course. Unless the company decides to make a large international push—typically very difficult for physical retailers—Home Depot will be restricted to slower growth by taking an increasing share of the U.S. home improvement market, along with Lowe's and smaller players like Tractor Supply and Floor & Decor. Home Depot also operates at the whims of the housing market and the economy in general—although home improvements (a less important but still impactful part of Home Depot's business) inevitably need to be made or the home crumbles, many things can be deferred during tough times, when homebuilding also slows. Therefore, we do not expect times will always be as good as they are today for Home Depot—and we value the business accordingly.

Fortunately, the stock market has taken "stock" of Home Depot over the past few years and marked up its valuation to perhaps 22x its most likely earnings for 2022—a healthy multiple for a company on the mature end of the spectrum serving a modestly cyclical end-market such as home improvement that is currently in the "up" part of the cycle. We therefore have to temper our expectations for Home Depot's future as an investment relative to its wonderful decade leading up to now. Given Home Depot's wide competitive advantages, continued growth, excellent management, and "fair" valuation, however, for now, we remain pleased shareholders.

MEDIA & ENTERTAINMENT GROUP

Media and entertainment businesses continue to be a challenging investment area. The industry remains extremely competitive and dynamic due to its exposure to changing technology infrastructure, including a large disruption in distribution due to content producers going direct-to-consumer combined with consumers "cutting the cord" and leaving traditional cable providers. Due to the vast and growing number of platforms available for content distribution and the multiple channels 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 disruptive "streaming content" offerings in this industry by companies like

Amazon Prime, Netflix, Apple, Hulu, YouTube, etc. As a result, over the past year, several legacy media companies that rely on advertising revenues to drive profitability continued to struggle with slower-growing comparative revenue and earnings. Clearly, it is important to choose media companies that have a special grip on the marketplace by offering exceptional content that continually attracts a range of advertisers and consumers, 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.

The 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 (such as virtual reality), Disney attains additional revenues and profits without incurring much of the original development costs. We refer to these re-launches from the company's film library as "accessing the Disney vault." That the content of this vault consists of gooses rather than golden eggs is an important investment point—the magic gooses keep laying golden eggs—e.g., *Snow White and the Seven Dwarfs, Pinocchio, Bambi, Cinderella, Alice in Wonderland, Peter Pan, The Little Mermaid, Beauty and the Beast, The Lion King, Aladdin, 101 Dalmatians, Frozen,* etc. We can envision our grandchildren's grandchildren watching many of these classic Disney films in the new millennium, no matter what future medium the content is delivered on. The value of the Disney vault is incalculable because of the 100-year annuity associated with producing iconic new films 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 CEO, Bob Chapek, has stayed the course executing on the long-term vision of his predecessor, Bob Iger, to expand Disney's invaluable library of content, broaden its distribution network, and embrace new technologies that complement and enhance the Disney experience. In addition, under Chapek's leadership, Disney continued to add new film franchises (i.e., golden gooses) to the Disney vault through the company's creative team, which remains unmatched in creating both animated and unanimated films for children.

Since Disney closed on its $71.3 billion acquisition of certain entertainment properties of 21st Century Fox in March 2019, the company has been aggressively integrating the acquired assets. This deal was 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 million and 18 million in its first year. Since its launch a few years ago, Disney+ has amassed more than 118 million subscribers. The Walt Disney Company is also majority owner of Hulu; currently, the number of subscriptions to Disney+, ESPN, and Hulu total 179 million.

The incredible subscriber growth across Disney's streaming platforms has propelled Disney even as production of films has been delayed due to ongoing pandemic uncertainty. In 2020, the release of the live action film, *Mulan*, kicked off a new direct-to-consumer service that brought theatrical releases to subscribers' home screens at the same time they were released in theaters. This service came at an extra one-time purchase price of $30 for Disney+. The $30 price is less than the amount it would cost a family of four to see the film at a cinema. Upon purchase, the film is added to the user's Disney+ library, available to be re-watched any time. In 2021, Disney added four more blockbuster films—*Raya and the Last Dragon, Cruella, Black Widow,* and *Jungle Cruise*—to its "Higher Premier Access" service, which contributed to the robust growth of Disney's overall direct-to-consumer revenue.

We remain enthusiastic shareholders of Disney, and believe the company's broad range of content offerings, growing international presence, and broad distribution capabilities will allow the company to extend its global reach for many years to come.

FIXED-INCOME INVESTMENTS

The Barclay's U.S. Aggregate Bond Index, which represents the broad debt market, experienced a 1.54% loss in 2021. In evaluating the current fixed-income market, we remain extremely cautious over the long term with any investment in most forms of fixed-income securities. If individuals stepped back and looked at their fixed-income investments in a similar manner to investing in a business, they would become skeptical about their prospects for 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 through a similar business lens. 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 at a 2.0% yield and chose to reinvest the coupon payments into those same bonds at par, it would take more than 35 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 2.0% 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. Unfortunately, today's abysmal return of 2.0% on a 30-year U.S. Treasury bond is guaranteed to lose money against inflation, which will likely average more than 3% over the next 30 years (once again, we will refrain from any actual forecasting, but current inflation is exceeding this average). 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. We believe that the current bond market remains in a bubble.

We continue to emphasize several points that concern us about fixed-income instruments: Besides the poor long-term yields they have been generating, 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 due to their increased borrowing at such low interest rates. We remain concerned about low long-term market interest rates, which are destined to eventually move upward based on the Federal Reserve's ultimate change of direction on maintaining a low interest rate environment while economic conditions remain challenging. As the economy recovers, unemployment improves, and inflation continues to rise, the Federal Reserve will seek to raise interest rates to minimize the chance of growing inflation negatively impacting the future economy. Ultimately, the Fed's action to raise interest rates would put 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, previous experience should remind us that the prophecy crowd is often wrong. Market interest rates could unexpectedly move upward at a faster rate and/or sooner than anticipated, which would quickly result in large losses on low-yielding, long-term fixed-income investments.

In 2022, we have ongoing tranches of fixed-income instruments coming due. We will elect to reinvest the proceeds in fixed-income instruments where we can find worthwhile securities that will provide a fair return. 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.

WHAT'S NEW AT FOUNDERS?

During 2021, Founders associates worked full-time at the office, and it felt good to reestablish our daily routine as an office—we missed being together. We consider ourselves lucky to work with individuals that care for others as they care for themselves. This "others-centered" vs. "self-centered" mindset permeates Founders, and we remain proud of the special culture in which we participate.

Transparency continues to be paramount to the success of any partnership, and we remain committed to communicating openly and fully with our clients and with each other. At Founders, each year we share a greater portion of our duties within the firm, allowing everyone to grow in their responsibilities. During 2021, Lisa has taken on further operational and regulatory compliance duties, including onboarding our new compliance firm. She executed our new compliance procedures and the associated software without incident, and we are grateful for the smooth transition. Ted continues to administer our security filings with the SEC (which is getting more complex), facilitates and manages trading along with relationships with trading firms, undertakes equity research, and completes crucial portfolio analysis. Jeff primarily focuses on broad equity research and works on capital allocation, as well as voting all proxies on behalf of Founders clients. Jeff also leads the University of Connecticut Student Managed Fund program and investment course, teaching and supervising highly selected students that are charged with managing a portion of the school's endowment fund.

I am grateful and feel lucky to be associated with such talented and skilled individuals while serving the best clients imaginable. Each of us at Founders Capital Management remains grateful for your business and for your faith in our stewardship. We thank you for the opportunity to serve you and for your continued trust. We look forward to working with you and continuing our shared journey in 2022.

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 holding.*

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

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

APPENDIX

Founders Company and Investment Culture

What Do We Focus On?

- **Act as business owners for the long haul,** as opposed to looking at investments as "paper to be flipped"
- **Act with "Rs: in mind: Reputation** (never lose it), **Responsibility (**always take it), **Reliability & Results (**focus on execution)
- **Act with character**—it's hard to describe, but we know it when we see it (when in doubt, always place others' interests before one's own)
- **Practice "mindful investing,"** fully understanding where our money is invested, as deep down as we can observe. Take complete responsibility for allocating capital, and do not abdicate money management and research to others
- **Understand the value of our held assets,** both those that are directly held and any investment with underlying assets
- **Care for clients and for each other**—collectively, we are Founders' greatest assets
- **Invest our own money as we invest for clients,** ensuring that we "eat our own cooking"
- **Maintain a human growth orientation** for individuals and clients over revenues and profits (size does not matter, but growing knowledge and embracing quality does; enrich the lives of those we interact with)
- **Seek and generate ideas, and learn from mistakes:** 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 lead 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, and 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 lies 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 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.