Resilience, Adaptability, & Humility

FOUNDERS CAPITAL MANAGEMENT
2022 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

2022 Annual Report:

“Resilience, Adaptability, & Humility”

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2022 PRINCIPALS' LETTER
From: Founders Capital Management

Resilience, Adaptability, & Humility"

"In the course of my life, I have often had to eat my words,
and I must confess that I have always found it a wholesome diet."
— Winston Spencer-Churchill

Market participants will remember the past 12 months as a year of turmoil. Inflation gripped our economic system and remained stubbornly high throughout 2022, and consumers contended with average price increases for goods and services of approximately 8%. As a result, the Federal Reserve decided to aggressively increase short-term interest rates to stem any long-term dangers to the economy wrought by persistent high inflation.

The Federal Reserve based its actions on lessons learned during the late 1960s through 1970s, when it had stood by watching inflation persist at an average of 7%+ per year—some of the highest rates of inflation in recent U.S. history. The Federal Reserve's previous procrastination in raising interest rates to slow the economy (to set off a cascade that would lead to lower consumer prices) led to long-term economic risks and financial instability for Americans. The Fed ended up finally crushing inflation (and the markets) in 1980 by raising short-term interest rates to 19%. To avoid repeating mistakes of the past, the Federal Reserve decided to take quick action on today's high-inflation environment by aggressively raising interest rates in a short period of time, precipitating market havoc in both stocks and fixed-income instruments. Throughout 2022, market volatility grew exponentially as investors became increasingly unsure about when, or if, the central bank would slow down, or stop, interest rate increases. The result: Down markets, with short-term interest rates that had been near zero at the beginning of 2022 hovering at around 4.5% by the end of the year.

Our focus in the 2022 Annual Letter is on business resilience, adaptability, and personal humility. Investors have thousands of companies to choose from, but very few have essential characteristics that position them to both bounce back from unexpected situations and adapt to new challenges to ensure a sustainably successful business future.

A lesson about humility: The Oak & the Reeds (Aesop's Fable #70)

> A giant oak stood near a brook in which grew some slender reeds. When the wind blew, the great oak stood proudly upright with its hundred arms uplifted to the sky. But the reeds bowed low in the wind and sang a sad and mournful song.
>
> "You have reason to complain," said the oak. "The slightest breeze that ruffles the surface of the water makes you bow your heads, while I, the mighty oak, stand upright and firm before the howling tempest."
>
> "Do not worry about us," replied the reeds. "The winds do not harm us. We bow before them and so we do not break. You, in all your pride and strength, have so far resisted their blows. But the end is coming."
>
> As the reeds spoke, a great hurricane rushed out of the north. The oak stood proudly and fought against the storm, while the yielding reeds bowed low. The wind redoubled in fury, and all at once, the great tree fell, torn up by the roots, and lay among the pitying reeds.
>
> *Moral:* It is better to yield with the winds of change than to resist stubbornly and be destroyed.

A critical key to investment success is understanding how to survive turbulent times. We have often repeated that our job is to be a good steward of capital, not unlike a good chicken farmer. It is important for a chicken farmer to understand fully that the farm's value is closely related to an expectation of the chicken flock laying an ever-increasing number of eggs. The farmer recognizes that his job, therefore, is twofold—to provide a secure environment in which the chicken flock can multiply and continue producing eggs, and to have a predictable view of the number of eggs the chickens will produce today as well as many years out. Very few chicken farms, of course, fit the description of a sustainable, resilient, and adaptable growing egg producer—so when a farmer owns one, it usually pays to hold on to it for generations.

The objectives of a successful investor are no different than those of a good chicken farmer—just replace the farm with a portfolio, chickens with a business, and eggs with money. Every investor wants to own a portfolio of sustainable, secure, resilient, and adaptable businesses in which he can ascertain, with a high degree of probability, today's value of money produced over a business' life. But there is caution in our story—just as a chicken farmer that focuses on chasing baskets of eggs—rather than keeping a keen eye on the chickens—will eventually lose much of his 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 run into financial difficulty and lose his security as well.

This year's letter will expand our discussion beyond sustainability and security as necessary attributes for creating value in a business to include resilience, adaptability, and humility. These essential character traits complement honesty, integrity, transparency, trust, and complete caring. We believe businesses that cultivate these ideals will stand the test of time and continue to benefit owners in the future.

* * *

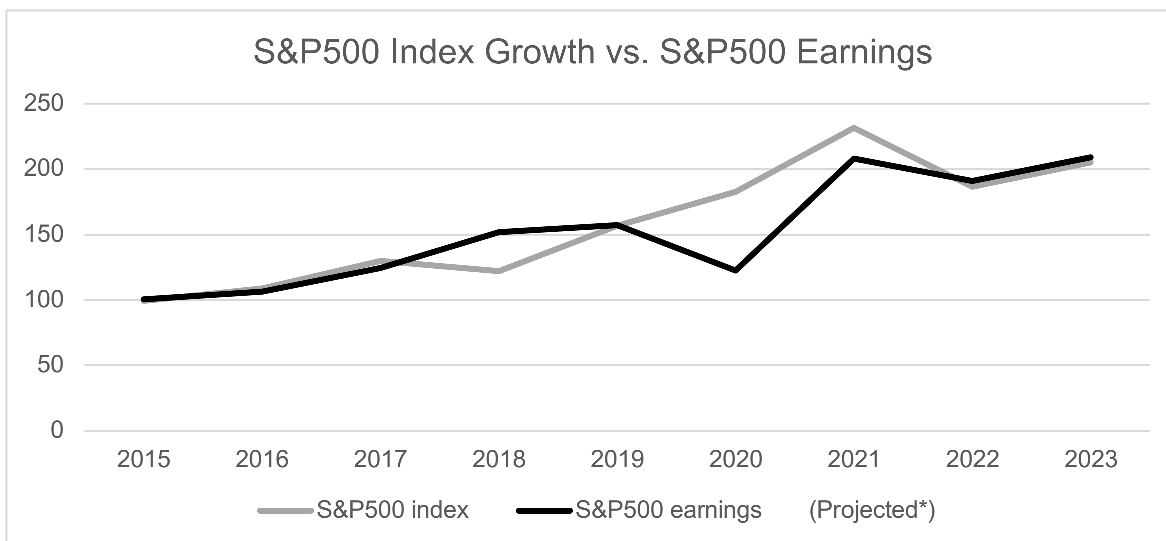
Last year, we pointed out the mercurial nature of the stock market in recent years. Looking back over the previous five years: The S&P 500 took a sudden 16% nosedive during a three-week period in December 2018, followed by a market recovery over the next 14 months that led to a 44% increase in the S&P 500 by the first quarter of 2020. Just when everything looked rosy again, the index faced a 34% freefall in just 33 days due to the sudden emergence of COVID-19. After 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 made a surprising ascent during 2021, with the S&P 500 ending up with a 28.7% gain for the year. This brings us to 2022, when the S&P 500 and Nasdaq unexpectedly suffered losses of 19.4% and 32.5%, respectively. According to a Fidelity Investments quarterly review of participant activity on 35 million retirement accounts, the average retirement account balance for 401k plans dropped 23% from the end of the third quarter of 2021 to the third quarter of 2022, plunging from $126,100 to $97,200. These portfolios comprised a mix of equities and fixed-income securities—clearly, there was no place to hide in 2022, and the market carnage has been widespread.

In hindsight, it seems that the only consistent thing about the stock market in recent years has been a roller coaster ride that has left everyone jittery and more convinced than ever that the stock market (and the fixed-income market now as well) is essentially a casino in which betting on short-term swings allows both bulls and bears to make money. This "gambling mentality" that has proliferated in the market has obscured a key foundational concept: **The stock market is supposed to be a mechanism for investing, not speculating.**

Over the past 12 months, investment sentiment took an overall turn from enthusiastic optimism to unchecked pessimism, leaving many investors wondering if participating in a gambling casino called the stock market is worth the pain. In 2021, we watched young investors jump into the "market game" to get a piece of short-term gains from cryptocurrency, cloud computing, electric vehicles (EVs), meme companies, and similar quick, money-making opportunities. Most of these companies realized low (to no) revenues and profits in 2022, after having traded at whirlwind multibillion-dollar valuations at the end of 2021. In 2022, the hurricane winds reversed, and many of these speculative "oak" stocks, along with many other stocks, were ripped from their roots and trounced to near oblivion.

The speculative money that blew with hurricane force into the stock market during 2021, accelerating price movements upward, has been replaced with a new kind of market trend: These days, any company that trades in the stock market that is generally associated with technology, communication, or social media should be avoided at any price. Assessing the value of these companies has little meaning. As a result, the Nasdaq has also been punished with large losses over the past 12 months. In last year's letter, we finished this paragraph with a warning: **Speculative behavior will end someday and badly impact the markets—we just don't know when.** Speculative behavior ended in 2022 and badly impacted the markets, and good companies in the affected technology, communication, and social media sectors were unfairly impacted as a result. But therein lies the break: Smart investors should keep an eye on potential investment opportunities in sound, long-term businesses that are currently trading at low valuations (and low prices).

Bookmaker behavior in the stock market notwithstanding, we will step back and evaluate the longer-term trends. An update to last year's chart assesses gains in price vs. earnings for the S&P 500 since 2015:



If we had placed $100 in the S&P 500 at the beginning of 2015, that investment would have turned into approximately $186.5 at the end of 2022, reflecting an annual return of approximately 8.1% over eight years. Now, let's assume (we're not predicting—this is just an illustration) that the S&P 500 grows with its expected aggregate company earnings during 2023. In this scenario, an investor's nine-year annual return would adjust to approximately 8.3% at the end of next year. This assumes, however, that interest rates remain at their current levels (an important disclaimer). In an environment of ever-increasing interest rates (due to persistent inflation) that acts as an anchor weighing down all invested assets, the markets could remain pressured in the upcoming year as well.

As a comparison, if we look at the growth in operating earnings for all companies in the S&P 500 over the same eight-year period, the S&P 500's collective operating earnings would have grown from approximately $100 to $190 per share by the end of 2022—representing an annual increase in S&P 500 operating earnings of around 8.3%. If the expected operating earnings for the S&P 500 grows to $209 in 2023, the annual growth in operating earnings would turn out to be approximately 8.5% over a nine-year period—nearly equal to the growth in the S&P 500 index in our outlined scenario. Again, rising interest rates associated with inflation lowers the future value of S&P 500 earnings, even though companies continue to grow—thus, the market can continue to undergo pressure if inflation persists.

The key point: Although the S&P 500 index's extreme price gyrations over the years resulted in drops and surges in excess of 25%, our exercise shows that the aggregate companies that make up the stock market

continue to grow their earnings over time, and the price of the market is a reflection of these expected earnings. Investors should understand, however, that the price of the market reflects today's assessed value of all future earnings that are expected to be discounted by an interest rate that is largely a factor of inflation. The higher the expected inflation, the greater the anticipated future earnings will be discounted, negatively impacting the price of all assets. This requires a discussion about inflation.

Inflation and Impact on Asset Prices

The market volatility in 2022, whose first six months featured the largest market downturn since 1970, prompted us to send our clients a mid-year communication explaining the circumstances that had led to the sudden market downdraft. The issues remain fresh and are therefore worth repeating in our annual letter:

*Inflation has reared its ugly head during the past few years of the pandemic era, where the annual consumer price index (CPI) has risen from 1.54% in March 2020 to 9% in June 2022. Given an ongoing rise in the CPI, the Federal Reserve decided to quickly raise interest rates to squelch any further rise in inflation that would bring us back to the experience of the Great Inflation era. From 1968 to 1983, there was an ongoing struggle with inflation that had entered the economy due to loosened monetary policies in the 1960s, when too much money was pumped into the financial system to create low unemployment and stimulate economic growth—sound familiar? During this 15-year period, the consumer price index surged 186%, or 7.3% per year (*Barron's*—August 1, 2022). Late in the game, the Federal Reserve raised interest rates to 19% to stifle the 15-year battle with heightened inflation that had reached a peak of 15% by 1980. Regrettably, due to a laggard Federal Reserve response to address this tricky situation head-on in the early 1970s, the stock market experienced a decade of stagnation as it was politically incorrect to induce a recession to address a growing inflation problem. (As a side note: Besides the 1980–1982 Fed-induced recession, there was a recession in 1973-1975 due to the oil crisis.) History may not repeat itself, but it rhymes, and the Federal Reserve today does not want to duplicate any mistakes made in the past. With this as background, it is a good idea to discuss how high inflation and interest rates impact the price of all assets, and then compare the past inflation faced in the 1970s to today.*

Where are we today, and how did we get here?

During the credit crisis of 2008–2009, the U.S. government worked diligently with the Federal Reserve to avoid a deflationary environment by aggressively lowering interest rates, rapidly feeding trillions of dollars into the financial system to enhance liquidity, and shoring up falling asset prices—all to keep America's financial gears moving. These actions were repeated during the pandemic crisis of 2020–2021. The response by the U.S. Treasury and Federal Reserve should be commended in each of these cases—their actions avoided a catastrophe associated with a long-term deflationary environment (think "1930s"). Unfortunately, in both instances, the financial impact was very deep. Since the financial crisis around 14 years ago, interest rates remained at historic lows, and money continued to be aggressively injected into the financial system to allow banks to heal, enable individuals and corporations to restructure their debt at lower rates, and limit the impact of extreme financial circumstances on the economy. Although the government and Federal Reserve wanted to ensure that our financial plumbing kept the monetary system flowing, low interest rates and free money tempted many individuals—leading to excessive borrowing, spending, and market speculation (think of the exploding interest in trading platforms like Robinhood and Coinbase to trade cryptocurrency).

Given the longevity of the central bank's actions, investors should pay heed to Isaac Newton's third law of motion: ***For every action, there is an equal and opposite reaction.*** *If the act of maintaining historical low interest rates and placing enormous amounts of money into the financial system are not reversible, through both raising interest rates and removing money from the system in the future, it is highly likely that we will enter an inflationary period—one that may be quite high. This scenario is not much better than a deflationary environment, as wage increases would likely fail to keep pace with the rising prices of all goods and services. Moreover, inflation has the largest impact on the long-term return of all types of capital, for both investors and businesses.*

What is inflation's impact on the price of all assets—cash, stocks, bonds, etc.?

Inflation can be likened to an economic tapeworm that damages the value of all assets, including cash. Unless this manifestation is controlled, the value of an uninvested dollar at the beginning of each year can deteriorate 10% under the scenario of 10% inflation. In essence, the cost of $100 of goods at the beginning of January will cost approximately $110 by December of the same year. Imagine repeating this problem every year into the future.

A drop in the value of most stocks under a high inflation scenario is due to the fact that many companies will experience rising costs for input goods to produce their products, with a slower ability to raise prices to their customers to offset increasing expenses. Under this scenario, if companies raise prices for goods and services too quickly, customer demand dwindles, further exasperating the organization's profitability. The only option for companies to salvage previous profits would be to aggressively cut expenses, including labor. However, this action also presents a two-edged sword to the problem, as draconian cost cuts could further erode a company's profitability if they are unable to keep up with customer demand—even if it has dropped a bit. Either way, under inflationary conditions, a company's bottom line is negatively impacted as profits (which is revenues minus expenses) can become squeezed. And if an inflationary environment continues, there is a negative spiraling impact on the profitability of most companies, as well as on the general economy.

Furthermore, investors will want more for their investment dollar in a high-inflation environment and will command higher returns. Translation: Prices for investment assets like stocks will go lower than expected based on a forecast of continued inflation that makes future profits worth far less in today's dollars. Why? Inflation has a substantial impact on the long-term return of corporate capital. To an investor, the important earnings are the "real earnings" a business produces for owners. "Real earnings" are determined by the extra purchasing power an investor achieves, having placed his money at risk. For example, let's say you decide to save for your child's college education. Suppose you opt to put aside $40,000 today for the anticipated first year of college in a decade. Given that you think tuition will increase 5% per year, you decide to put the $40,000 in a tax-exempt bond earning approximately 5% per year. At the end of 10 years, the $40,000 will have grown into approximately $65,000—not bad. But how would you feel if, at the 10-year point, you discovered that the first year's tuition bill had inflated to slightly over $82,000 due to 7.5% annual inflation experienced over the past decade? You certainly would not feel very savvy, having produced no "real earnings" from your initial investment after10 years. If inflation reaches a high enough rate, it can make the purchase of various assets unappealing.

Inflation has an outsized influence on the cost of business capital because passive returns, like a tax-exempt bond, will most likely keep pace with inflation and be benchmarked against corporate returns. For example, during a period of 10% inflation this becomes the minimum benchmark for an investor's cost of capital, as well as his expected return on a tax-exempt investment. A corporation must compete against this passive investment alternative to attract investor capital. For example, if a corporation is achieving a 12.5% return on its invested capital and distributing all its profits to owners, it will not produce"real earnings" for its owners. The problem lies in the fact that the 12.5% return for owners may be taxed at 28% or more, leaving a 9% real return. The 9% return gives the investor only 99% of the purchasing power he originally had at the beginning of the year. In the early 1960s, it is our estimation that the average corporation achieved an 11% return on its equity capital. It is no wonder that the high inflation experienced in the late 1960s and throughout the 1970s negatively impacted the average company's stock price. Although we can be comforted with the knowledge that the average return on a company's equity capital today has risen to approximately 16%, under a scenario of 10% inflation, we can see that there would still be a large deterioration in value to stockholders if the inflation tapeworm ate away at a large portion of corporate returns.

An increasing rate of inflation also creates an environment in which a "double tax" can be assessed against a company's capital. Let's assume an automobile company faces tremendous global competition and has constant difficulty raising prices without losing some share of the market. This company inhabits a highly capital-intensive industry, in which the development of a new vehicle or the addition or retooling of plants can

cost billions of dollars. During a period of high inflation—let us say 10%—this automobile company may be forced to hold back certain capital expenditures due to high interest rates and the corresponding high cost of capital. Competition makes it difficult for this company to raise prices 10% to their customers to keep pace with inflation. If the company decides to wait for better times to make significant capital investments, its current annual earnings and dividends may continue to grow, albeit at a slower pace than 10%. A hidden problem is occurring, however. Capital costs associated with replacing worn-out plant and equipment to build the same number of units is most likely growing along with inflation at 10%. This so-called inflation tax will be a significant factor in the future when this automobile company needs to replace or add plant and equipment at a much higher cost. All earnings produced during the inflationary period, and maybe more, will be needed to ensure the future survival of this company.

How much safety is in fixed-income investments (bonds)?

Many think that balancing a portfolio with fixed-income securities will mitigate the loss of purchasing power in a high-inflation environment. Under normal circumstances, this may be somewhat true; however, inflation can eat away at fixed-income returns in an even greater fashion to stocks. Prior to inflation rearing its ugly head, if it were possible to purchase a safe fixed-income instrument at par that provides 10% tax-exempt interest, an investor would be able to protect his principal investment value if inflation were equal to the fixed income return of 10%. However, we are not in normal times—fixed-income rates of return receded to near-zero for securities such as short-term government bonds due to deflationary challenges that were faced over the past 14 years that have impacted all fixed-income returns. Imagine if an investor purchased a $10,000, 10-year government bond at the beginning of 2022 that guaranteed 1.5% interest per year. If inflation suddenly went to 10% (it was at 9% in June) and the 10-year government bond rate eventually followed the inflation rate, then the value of this bond would deteriorate if the investor decided to sell it. Why? The annual $150 fixed amount received on a January 2022 purchase of this $10,000 investment over a 10-year period becomes less desirable as the new interest rate requested on a government bond could rise to equal inflation, or 10%. No buyer will pay $10,000 for a bond that has nine years left that only pays $150 each year when they could alternatively place their money in another $10,000 government bond that may provide them $1,000 of interest per year, or 10%.

It is no wonder that the average bond in the aggregate fixed-income market is down 15.4% at the end of 2022. And if inflation and interest rates continue to rise, the value of long-term bonds will worsen and unlikely recover. Conversely, stocks will recover as many companies raise prices over time and keep growing their businesses—moving their profit train forward. There is more flexibility for companies to balance their business by reducing costs and raising prices over time to offset inflation than there is for a long-term, fixed-income instrument holder to adjust a low-interest, fixed-coupon payment on their security.

How is today's inflation experience different from the Great Inflation period of the seventies?

With the above-stated inflation impact, it is our opinion that inflation today is a bit different from the inflation experienced during the 1970s. Why? We have a disrupted supply chain, whereby the shipment of goods around the world has been impacted due to the pandemic over the past few years. This has led to a greater demand for goods than can be supplied—leading to increased prices. However, this may prove to be temporary as the pandemic subsides (especially in China) and the production and shipment of goods normalizes in the near future. Additionally, the price of oil and gas has been impacted by the Russian invasion of Ukraine—there is an ongoing interruption for a great portion of exported Russian oil and gas, which has resulted in a disrupted supply chain that has led to higher oil and gas prices. As increased production works its way into the system to replace Russian oil and gas production—from other producing countries like the U.S.—it is hopeful that today's high oil and gas prices will also subside. However, the timing of any adjustment to the above challenges is unknown, and the pandemic's persistence in China can continue to disrupt the global supply chain. [Since our mid-year communication, China is experiencing a pandemic setback with Covid after lifting its "zero covid" policy in December, and significant new supply-chain problems can be expected in the first half of 2023.] And oil and gas prices can remain high (or head higher) as replacing any gap in Russia's oil

and gas production may take longer than expected. Clearly, the above issues are unpredictable at this time, and inflation has entered the economy largely due to these strains, as well as a labor shortfall and an ensuing demand for higher wages. Thus, the Federal Reserve has decided to raise interest rates aggressively to stem further inflation impacting the economy—it wants to get inflation under control.

Is this an abnormal market downturn? How should I contextualize the recent losses?

In the 20th century, there were 15 separate occasions on which the market declined at least 25% from top to bottom—roughly once every six years, although not in any regular six-year rhythm. In some cases, the decline was even greater—greater than 50% measured from top to bottom. In every case, the market recovered and went on to new highs, usually within a year but, on a few occasions, the new highs took several years to surface.

Unsurprisingly, 22 years into the new century, we have now seen four declines of the same 25% magnitude: The recession of 2000-2002, the Great Financial Crisis of 2008-2009, the initial COVID lockdown crisis of 2020, and the 2022 market drop (intraday lows in June, 2022 were close to a 25% peak-to-trough drop). The "correction cadence" continues to average one 25% drop every six years although, unfortunately, the most recent two came in quick succession.

While we are investors instead of market predictors at Founders, we do keep these historical regularities in mind and invest with them in mind as well. The lesson of the last 122 years is simple and clear: Large, regular declines are part of the experience of being a stock market investor. Avoiding them through prediction is nearly impossible: Market predictors call for a market drop every single year and, as discussed in our next question, even a little market timing can be a large mistake.

Market corrections are "par for the course" and tend to come during periods of high returns—keeping tall trees from growing to the sky. The math of stock market expectations is inescapable: In an economy in which the Gross Domestic Product (GDP) or Gross National Product (GNP) grows at a single digit rate—which the U.S. will assuredly do on an inflation-adjusted basis—the market can only grow at a similar rate, while also offering a few extra points per year in dividends and share buybacks. Equaling the 9%-10% long-term total returns cited by many investment publications. Periods of 15% or greater annual returns, which we had been experiencing before the recent drop, do not last indefinitely—and, in fact, the higher-than-normal market returns in the past are closely associated with a period of lower interest rates that increase the value of all assets. Unfortunately, rising interest rates can have the opposite effect, placing an anchor on any growing value of assets. If interest rates remain high (due to persistent inflation), the market could see multi-year periods where returns normalize toward the long-term average – translation…back toward 9%-10%. Basically, a so-called reset of all asset prices can result in a lower market valuation, which could take place under a scenario where long-term interest rates remain higher in the next 10 years compared to the past decade.

Given the current market uncertainty, why not anticipate a market downturn and sell stocks while they are high and then buy at the low?

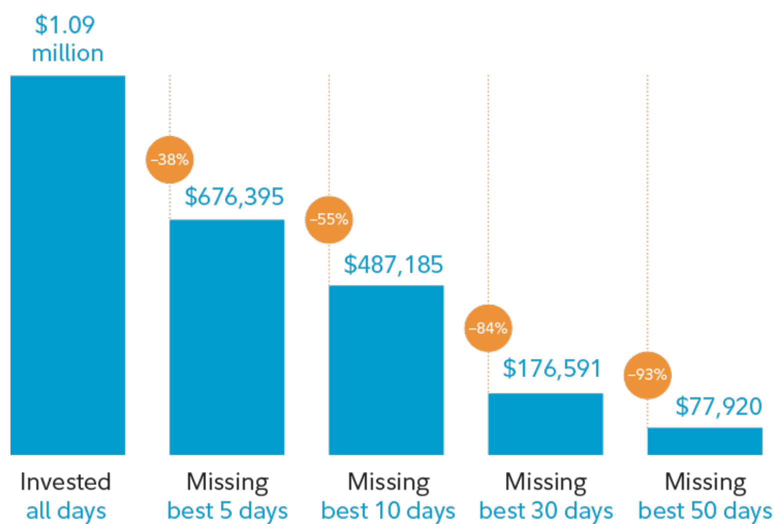
We answer the "stay in or get out of the market" question frequently, and we will repeat with absolute certainty what we have stated in the past: We are not aware of the existence of any accurate near-term macroeconomic or market forecast and cannot predict the eventual impact of unforeseen events on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

In 1994, University of Michigan Professor H. Nejat Seyhun published a study, "Stock Market Extremes and Portfolio Performance." Although this study is 29 years old, its findings are insightful and remain relevant:

Between 1926 and 1993, more than 99% of the total dollar returns were "earned" during only 5.9% of the months. ***For the 31-year period from 1963 to 1993, 90 trading days accounted for 95% of the market gains.*** *The implications of this study could well be critical for the average investor. By being "out of the market" for*

as few as even one or two of the best-performing months or days over several decades, a portfolio's return is significantly diminished.

Timing the market and "selling at the high, and reinvesting at the low" is something that we have not witnessed anyone master, and we have followed and studied a great deal in this area. Although the above fact provided by Professor H. Nejat Seyhun is true, one may conclude that it is possible to time the up versus down months of the market. Unfortunately, there is uncertainty surrounding the "up days" as opposed to the "down days" within these months. For example, another amazing fact: If an investor missed out on the best 50 trading days out of 10,250 trading days in the past 41 years (from 1980 to 2021), a $10,000 investment in the S&P 500 would have turned into approximately $77,000. If she had kept her money in the market for the full 10,250 trading days (staying in the 50 best trading days), her $10,000 would have turned into approximately $1.1 million. Just looking at these above statistics supports data that displays it is nearly impossible to time the market (see chart below).



https://www.fidelity.com/learning-center/wealth-management-insights/3-reasons-to-stay-invested

A professional gambler looking at the odds of success in this scenario would choose to stay in the market, knowing it will eventually recover and increase further in the future—even in retirement accounts, where there are no capital gains tax implications for selling. In taxable accounts, the odds of success for selling a portfolio at the high, paying approximately a 30% total tax on past gains (forcing a loss on future returns), and picking the bottom of the market to reinvest (while attempting to compensate for the negative tax sale implication) is almost impossible. Readers will logically understand that among the many trading days, the 50 largest trading days with positive moves are represented via a market bounceback during challenging periods—increases that occur in a noticeably big way. Knowing the positive 50 large trading days during a market setback out of 10,250 trading days over 41 years is statistically impractical to predict; however, they are easy to miss.

At this point, we need to remind everyone that we are never going to attempt to call a market bottom—the market uncertainty is likely to continue. So, what do we know with certainty? We know that the global economy, as well as the businesses that participate in this economy, will continue to grow at a steady pace over time and that the market will likely be worth more 10 years from now than it is today. Given these facts, we remain focused on the long-term growth of our businesses in a global economy, their underlying strategies, their growth in market share, and their improving positions within their respective industries—as opposed to focusing on what is happening with individual or overall stock prices due to economic or political forecasts

that are certain to be wrong. We also know that based on economic metrics, now and in the future, many of the companies in our portfolio are currently trading below their intrinsic value—some significantly.

Business Resilience and Adaptability

In last year's letter, we discussed the importance of evaluating business "sustainability," given the increasing speculation-driven investment behavior among market participants. Many professional money managers even ignored "stodgy old" companies that appeared to provide lower-than-average returns; their interest moved to high-growth, disruptive stocks that they believed would provide "better-than-average" immediate investment returns. These professionals bought emerging companies that promised "high, immediate returns," but that actually came with less certainty and little to no economic value. Investors rationalized their actions with this belief: "To obtain higher returns today, we need to invest early in recognized disruptive businesses that have a long runway into a new future." According to this thinking, to obtain high-octane returns, you needed to get on the bandwagon and chase rising investments in speculative, disruptive businesses like Carvana, the online platform for buying and selling cars (down 98% this year) or Coinbase, the crypto exchange platform for buying and selling cryptocurrencies (down 86% this year). Many investors decided that these businesses, along with others, had the potential to achieve the greatest disruption and highest increase in stock price—with no regard for their value. In all these cases, "the future looked so bright, the investor had to wear shades"—until dark days emerged.

An analogy to this speculative activity: Imagine an opportunity to make a lifetime investment in a group of graduate business students in exchange for a portion of their future earnings. Should we place our hard-earned investment money with the most disruptive students in the class—the ones that seemed to be "where the action is"? Or should we look to the students that were consistently honest, hard-working, critical thinkers that acted with integrity? In other words, prior to investing money, would we reactively go with the students who promised a "long runway" of mayhem, or would we conduct research to identify the graduates with sustainable attributes—the intrinsic qualities that would provide us a sense of long-term security in our investment? We would choose to place our funds in the group of focused and steadfast students as the more validated and promising investment.

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

We can also conclude that a responsible investor does not act like a gambler who makes uninformed guesses about the next roll of a stock. Instead, an investor should work to understand what truly "counts" when investing in a particular company. We have identified what we believe counts when determining the difference between "what value is" and "what is valuable." Valuable businesses possess the four "ables":

- **defend*able*** businesses that are difficult for competitors to penetrate
- **sustain*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

This brings us to the next level of this discussion—investing in sustainable businesses that are positioned to be **resilient** and **adaptable**.

Although sustainable businesses that have the described "ables" create economic value by producing distributable owner earnings over time—and are able to reallocate a portion of their earnings effectively to achieve future growth in intrinsic business value—it is important that these companies are also resilient and

adaptable—possessed of the necessary attributes to make it through inevitable changes and disruptions in their sectors and enable them to survive over the long term.

Investors must therefore be mindful of a company's resilience and adaptability when considering whether to invest. Why? Let's go back a little more than 65 million years ago, when dinosaurs inhabited the earth. We know that these magnificent creatures dominated the planet—in fact, at that time, if we were going to invest in a group of creatures over the next 100 years, we would have placed a large amount of money on the sustainable growth of dinosaurs. They possessed all our desired business attributes—they were *defendable*, and difficult for competitors to penetrate; *sustainable,* and could be viewed many years out (they had already been around for more than 150 million years); and *predictable*, given that they controlled a dominant market share of the earth's ecosystem and resources. Around 65 million years ago, however, unexpected disruption occurred when an asteroid hit earth and led to the eventual extinction of the dinosaur population. These previously dominant creatures were unable to be resilient and adapt to earth's climate change. Astute prehistoric investors might have instead placed their money into certain bird populations that proved to be resilient and able to adapt to the changing environment.

Disruptions are like asteroids that hit industries, impacting everyone involved, including the investors. Consequently, every company must monitor potential catastrophic risks to its business based on the assumption that, inevitably, an asteroid strike will create climate change in its sector. Companies that aren't resilient and are unable to adapt to a fast-paced and changing competitive landscape are destined to become extinct: Kodak, Xerox, and Sears are just a few of the many iconic companies that expected to be around for another hundred years but were blindsided and quickly devastated. Other once-impenetrable companies rocked by disruption include IBM and General Electric. Clearly, companies in the coming decades need to be ultrasensitive to possible disruption to their businesses and should understand the importance of resilience and adaptability for survival.

Before isolating the business attributes that enable a company's resilience and adaptability, let's step back and review several intertwined business dinosaurs that were unable to survive an industry asteroid strike. Studying past business extinctions can help an investor understand how disruptions can lead to a company's demise and how to anticipate their potential occurrence in the future, empowering them to avoid the investment graveyard, e.g., by selling a business, or by forgoing an allocation of capital altogether or at the wrong time.

Eastman Kodak

George Eastman founded the Eastman Kodak Company in Rochester, New York in 1884. In 1888, after introducing the first Kodak camera, Kodak adopted a business model now known as the "razor and blades" model (a term popularized by the founder of Gillette) whereby the company sold inexpensive cameras and earned large profit margins from the ongoing sale of consumables—film, chemicals, and paper.

Using this business strategy, Kodak dominated the photographic film industry for more than 125 years, reaching an 80% market share in the U.S. and about 50% globally. Once people began taking photos via their cell phones and digital photography became prevalent, however, Kodak's lucrative business model became an anchor that destroyed the company. Kodak eventually filed for bankruptcy in 2012.

The Kodak tragedy is a great example of how an overreliance on a single, specific business model that is difficult to pivot from can become a lethal blind spot. With nearly 100% of its profits reliant on an obsolescent, dying product (the camera and associated film, chemicals, and paper), Kodak's ability to be resilient and adapt to a new business (or business model) after digital cameras emerged on smartphones became nearly impossible.

When a company is anchored firmly to a lucrative business model, beware of the emergence of a long-term industry disruption that could dissipate profits quickly and permanently—in Kodak's case, it took just 10 years. There is virtually zero flexibility in a business once the core product becomes obsolete, and an entrenched business model precludes the company's ability to respond or adapt to the changing conditions. We call this business dilemma a "Kodak moment," and it represents an investment picture that should be avoided at all costs.

Xerox

Xerox Corporation—another Rochester, New York company, founded in 1906 as the Haloid Company—originally manufactured photographic paper and equipment (note the initial relation to Kodak). In 1935, the Haloid Company acquired Rectograph, a photocopy machine manufacturer that used Haloid paper. The rest is history, and in 1958, the company formally changed its name to Haloid Xerox to reflect the company's focus on commercial xerography. Xerox's business model was similar to Kodak's—the company sold and/or leased the copier at near-cost and profited from servicing the copier as well as the sale of consumable paper that worked specifically with the Xerox copier.

Xerox also became one of the most innovative companies globally, mainly because of its Palo Alto Research Center (Xerox PARC) that developed technologies for the future. Many successful products were invented at PARC, some of which have revolutionized the digital world, including the personal computer and the graphical user interface (GUI) that was popularized by the Apple Macintosh and Microsoft Windows. Like Kodak, however, Xerox was unable to move beyond its razor-and-blades business model, believing that the personal computer and associated GUI-based operating systems would never be consumable products in the future.

Xerox's board deemed the PC and associated innovations that had been developed at the Xerox PARC "not worth pursuing." At the time, Apple was already a hot technology firm, and Steve Jobs proposed a deal: He would allow Xerox to buy shares of his company if he were allowed to visit PARC to learn about its inventions. Using PARC's work as inspiration, Jobs created the Macintosh, which became a legendary success. Apple succeeded based on Xerox's inventions, and Microsoft succeeded in copying the GUI from Apple, which led to Windows. Meanwhile, Xerox was fading into oblivion as much of the work traditionally performed by copiers became digitized (enter Adobe, which also emerged from Xerox PARC). By 2001, Xerox was on the brink of bankruptcy, loaded with $17 billion of debt.

This is another example of a company that was anchored tightly to a lucrative business model—until a long-term industry disruption emerged with the potential to dissipate profits quickly and permanently. The irony of Xerox is that it's a company that is known for copying—and yet Apple and MacIntosh succeeded by copying from it. Xerox's tragedy is that it literally invented the future of personal computing and yet failed to capitalize on its innovations. The company's overreliance on being a "copier company" precluded the business from responding and adapting to a changing marketplace.

Sears: Buried in the Retail Cemetery

In 1886, Richard Sears founded the R.W. Sears Watch Company in Minneapolis, Minnesota to sell watches by mail order. The next year, he relocated his business to Chicago, hired Alvah Roebuck to repair watches, and published a mail-order catalog offering watches and jewelry. Sears sold his business in 1889 and, in 1893, he co-founded another mail-order operation with Roebuck that came to be known as Sears, Roebuck and Co. Through their mail-order catalog, Sears, Roebuck grew phenomenally, selling a wide range of merchandise at affordable prices to farmers and villagers that had no other convenient access to retail shopping. The U.S. Postal Service's initiation of free rural delivery in 1896 and parcel post in 1913 enabled Sears to send its merchandise to even the most isolated customers.

Sears' business model allowed the company to scale rapidly and displace legacy retailers like Woolworth to become the largest retailer on earth. Woolworth and other retail stores around the country fell victim to the flexibility and reach of Sears, whose mailed catalogs offered consumers a convenient way to buy a changing array of merchandise at low prices. Customers across the nation could order by mail (and, eventually, by phone), and have Sears' vast warehouses deliver goods through the postal system. (Sears was the Amazon of its time!)

Sears used its disruptive power to expand a retail empire, building Sears stores throughout the nation. Sears also diversified into insurance (by acquiring Allstate), financial services (by acquiring the brokerage firm, Dean Witter, and by developing the Discover card), and real estate (by acquiring the Coldwell Banker Real estate group).

Ultimately, Sears fell victim to its own success. The company had initially built tremendous flexibility into its business model through its catalog operation but eventually became anchored down by building high-cost locations throughout America. The company was further weighed down by its need to manage multiple complex businesses.

Retailing is a tough business that requires managing a multitude of moving variables such as customer service, location selection, merchandise assortment, price attraction, and efficient delivery options. To produce value and succeed, retailers need to scale and anchor their companies around customer service, location, assorted merchandise, distribution, and price. The scaling and anchoring aspects, coupled with many other moving variables, can become a problem if the retail environment changes.

Many companies ended up buried in the retail cemetery, with legacy locations and business models that became difficult to maneuver from, even if they had recognized that disruption was taking place in their industry. The failed retail names are too many to mention, but here are a few: JC Penney, Lord and Taylor, Neiman Marcus, Blockbuster, Radio Shack, Borders, Toys "R" Us, and Circuit City. Soon to join their ranks: Bed, Bath & Beyond, Party City, and Rite-Aid.

International Business Machines (IBM)

IBM originated as the Tabulating Machine Company in 1896, specializing in the development and sale of punch-card data-processing equipment. Thomas Watson, Sr. became the general manager of the company in 1924, and the company grew rapidly under his leadership. Although IBM continued to grow through the Great Depression era, the company's big break came after the passage of the Social Security Act of 1935, when IBM secured the U.S. government contract to maintain employment data for 26 million Americans. This project, described at the time as the biggest accounting operation of all time, led IBM to secure other U.S. government contracts, including chief developer of computers for the U.S. Air Force's automated defense systems during the 1950s. In the 1960s, IBM emerged as the largest technology company in the world, dominating its competition with a 70% market share for mainframe computers.

IBM's business model was built on a vertically integrated strategy: The company developed and built most of the key components for its mainframe computers in-house, including processors, operating systems, peripherals, and databases. This all-encompassing product offering allowed IBM to capture high profit margins while capitalizing on a reputation for technical know-how and exceptional service. In the mid-1970s, however, a sea change occurred as Steve Jobs and Apple Computer introduced the personal computer (PC), setting the stage for IBM's fall from industry supremacy.

Due to IBM's large size and industry dominance, the company underestimated the impact of the PC on its mainframe business. By the time IBM decided to enter the PC business, the company had no choice but to outsource the microprocessors and operating system to Intel and Microsoft. IBM's greatest mistake was purchasing the operating system from Bill Gates of Microsoft in a deal that allowed Microsoft to retain the rights to license the operating system to other PC manufacturers. The rest is history: In the ensuing decades, Microsoft and other computer companies dominated the technology industry by developing software and hardware. As personal computers and mid-size mainframe computers became more powerful, IBM's mainframe business declined significantly. IBM's prominence in the technology industry deteriorated drastically and is still under challenge today.

A company can become anchored, stubbornly adhering to a business strategy that relies on its past strength. This lack of adaptability eventually shackles the business when rapid technological change hits an industry. Any response to business change in this case is often not nimble enough to respond resiliently and to adapt to a transforming industry. (Full disclosure: Years ago, we owned IBM for a while due to our interest in its development of artificial intelligence, but we realized our misallocation and redeployed our capital to Google/Alphabet.)

The Conglomerate and Business Roll-Up Cemetery

Teledyne Technologies

One of the most famous conglomerates of the past century was managed by Henry Singleton, who built Teledyne Technologies into an investor's dream. An investor in Teledyne stock in 1966 achieved an annual return of 17.9% over 25 years, or 53x return on his initial investment, in contrast to 6.7x for the S&P 500, 9x for General Electric, and 7.1x for other comparable conglomerates. This record places Henry Singleton alongside Warren Buffett as one of the greatest capital allocators of all time.

Despite this great success, a close study of Teledyne is warranted. Why? Henry Singleton grew Teledyne through an aggressive series of acquisitions, artfully building the company's earnings through a management system that delegated operations of each acquired company to select managers while holding them responsible for delivering profits (cash) to the holding company. Henry's annual budget-planning sessions with subsidiary leaders became legendary; he would ruthlessly subject managers to questions about capital allocation and dismiss as frivolous any plans to invest funds in ventures he believed would lead to lackluster returns. Essentially, although managers were free to run their businesses, they were intimidated into providing returns to Teledyne that met Henry's ultimate objective of bringing lots of cash to the holding company.

In due course, the managers' mandate to run each business as a cash-generating machine became their primary focus. Capital expenditures for plant and equipment—along with research and development necessary for certain businesses to flourish—went ignored, and a slow cancer metastasized within the companies. In the meantime, Henry used cash generated from Teledyne businesses to aggressively repurchase Teledyne stock, eventually repurchasing 75% of the company's stock in the open market—significantly raising the stock price and pleasing investors.

Cutting to the chase: At the end of Henry Singleton's Teledyne era, the conglomerate juggernaut started experiencing tremendous problems. In the early 1990s, Teledyne became the target of numerous lawsuits related to its government work, including accusations of falsifying missile test results, lying to cover up commissions on sales of military goods to Taiwan, and bribing both Saudi Arabian and Egyptian officials to procure contracts. In April 1994, Teledyne settled cases totaling $112.5 million—at that time, one of the largest settlements by any military contractor. Teledyne subsequently spun off several companies, combined with Allegheny Ludlum in 1996, and then split into three separate public entities in 1999, one of which was called Teledyne Technologies, which exists today. Teledyne Technologies resurrected the old Teledyne "growth through acquisition" strategy. We shall see how it goes.

Many conglomerates attempting to emulate the Teledyne "run the business by the numbers" model emerged during the 1960s throughout the late 1990s, including General Electric under Jack Welch. Unfortunately, nearly all these conglomerate behemoths ended up failing in some way—some, like GE, catastrophically. Here is a short list of renowned conglomerates that have gravestones in the conglomerate cemetery, most either having been broken up or having most of their businesses sold: Teledyne, Westinghouse, General Electric, Tyco, Gulf and Western, ITT, LTV, and TRW.

Business Roll-Ups

We regard investing in business roll-ups as similar to investing in complex conglomerates that are built through diverse acquisitions. A roll-up is a process used by investors (commonly private equity firms) to buy up multiple small companies in the same market and merge them into one large entity to increase purchasing power, achieve greater brand recognition, and lower capital costs. Our experience shows that more than 50% of roll-ups have failed to create any value for investors. As with conglomerates, we can cite many industry roll-ups that were afflicted by fraud and ended up in the roll-up cemetery—among them MCI WorldCom, Philip Services, Westar Energy, Enron, Chesapeake Energy, and Valeant Pharmaceutical.

A strategy for growing via aggressive acquisitions and extreme management can create incentive systems for executives that eventually contribute to the emergence of a "cheat mechanism" in the organization that leads to

scandals such as bribery and accounting fraud. Eventually, businesses that are run purely by the numbers end up run into the ground as a result of corporate (and investment) failure.

The takeaway regarding conglomerates and roll-ups: If an investment opportunity involves buying into a complex scheme that is ultimately difficult to understand and has an inherent high probability of ending badly, why do it? The perfume of returns always hides the stench of risk—until it wreaks havoc.

Business Resilience and Adaptability

Since we reviewed businesses that are anchored down in ways that make them vulnerable to the investment graveyard, we should also review companies that embody positive attributes of resilience and adaptability that position them for long-term survival.

If being anchored by a legacy business strategy that is difficult to maneuver from can be a detriment to any business, one would think that investors should seek the opposite—a business that is not overly encumbered by a business model that is vulnerable to disruption. The problem with this thinking is that just about every great business relies on a business model or strategy that provides an impenetrable moat that makes it difficult for competitors to penetrate—think of Google's search engine. In the end, business resilience and adaptability can coexist with an entrenched business strategy if that strategy can only be *slowly* eroded—providing essential time needed for the company to adapt during the disruption.

Let's look at a well-entrenched, non-capital-intensive business that tends to gush cash: PepsiCo, the beverage and snack company. PepsiCo is a major stronghold of these two industries that have developed during its corporate life over the past 100+ years—and these core industries have not materially changed over time. The large, slow-to-change beverage and snack industries have allowed dominant participants to achieve high and consistent returns on capital.

What makes PepsiCo resistant to competition and any quick erosion to its franchise? As fast-consuming commodities, sales of beverages and snacks depend on distribution channels. Over the past century, PepsiCo has built a flexible and impenetrable distribution system that is difficult to duplicate—this thwarts most competitors from entering its market and developing scale. In fact, most times, if a competitor does enter the market, it is better off making an agreement with PepsiCo to use the company's distribution system to deliver its products to markets vs. attempting to build its own distribution system. This industry "tollgate" provides PepsiCo's businesses tremendous resilience and adaptability if any industry disruption should emerge: To minimize or eliminate new competition, PepsiCo is positioned to deny access to its distribution system in favor of purchasing an emerging competitor or developing a similar product. (It is worth noting that Coca-Cola is in the same category as PepsiCo. For example, due to its impenetrable distribution system, the energy drink manufacturer, Monster Beverage, executed an agreement for Coca-Cola to distribute its product in exchange for Coca-Cola purchasing nearly 20% of the company. Coca-Cola now holds an option to purchase Monster Beverage in the future.)

Another business that embodies resilience and adaptability is Microsoft. In 2013, Microsoft was deemed a lost business by many technology pundits due to the company's inability to adjust to new technology that was overtaking its Windows franchise. At the same time, however, a very large portion of Microsoft's business—its growing cloud services segment—continued to blossom. The key to Microsoft's cloud service division was Microsoft's globally ubiquitous "Office" application products—specifically, Excel, Word, and PowerPoint. These applications hold a dominant market share, and when Microsoft moved Microsoft Office to its cloud platform, offering a subscription service for their use (now called Microsoft 365), corporations flocked to the service as a convenient way to maintain these necessary applications. The rest is history: As corporations began using Microsoft's cloud services, they also started subscribing to new Microsoft cloud products that integrate with Microsoft Office including the SharePoint collaborative platform, the Azure cloud computing platform, and the Teams business communication platform. Ultimately, the ubiquitous use of the Office

franchise provided Microsoft the resilience and adaptability it needed to evolve beyond its core Windows franchise (which remains a dominant business) in the fast-growing cloud computing ecosystem. In addition, Microsoft's new cloud-based application products provided the company an opportunity to deepen its roots with businesses throughout the world. Competitors now find it difficult to copy Microsoft's integrated and growing cloud service offerings.

The trick for investors is to weigh business resilience and adaptability against potential returns. Companies like PepsiCo, Coca-Cola, and Microsoft are recognized by all investors as steady businesses that provide consistent returns over time, and thus they normally trade around their intrinsic value. In other words, you rarely get a large discount on these types of businesses, but a consistent and moderate return does not mean an investor should shy away from owning a wonderful business at a fair price.

* * *

In the future, Founders' market behavior will remain simple: We adhere tightly to our value investing philosophy, and we seek to invest in sustainable and secure businesses that can be resilient and adapt to change. 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 patient vigilance. Given the increasingly uncertain market behavior of recent times, we are keeping one of our favorite quotes top of mind:

> **"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: 2022 Highlights

The intrinsic value of our aggregate equity holdings held steady during 2022, despite a tremendous gyration in many of their prices. We currently remain positive about our capital allocations, including expected returns over the next 10 years—despite any short-term price changes (some drastic) that surfaced this past year and that will likely continue into 2023.

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 aggregate portfolio** and believe that the companies are managed in a resilient 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, resilient, and able to adapt to a changing marketplace.** Our companies possess a long-term competitive advantage in their respective industries and have earnings capabilities that are sustainable over the foreseeable future.

As long-term investors, we are confident that the wonderful franchises in which we have an ownership stake will continue to strengthen their long-term enterprises, independent of any short-term gyrations in their stock prices.

The following is a summary of business highlights from our portfolio companies during 2022, along with our expectations for 2023.

CONSUMER GROUP

Consumer-related businesses will face challenging economic and competitive conditions in the coming year due to inflation, which may dampen demand for their products. Nevertheless, we are pleased with the resilient performance of our Consumer Group in 2022, expect to see continued positive results during 2023, and remain optimistic about the long term outlook for our global consumer franchises—specifically PepsiCo (as well as Coca-Cola, which is a smaller position).

PepsiCo

Our primary consumer holding—PepsiCo—had a very good year, despite inflation headwinds that caused its cost of goods to rise during 2022. Reported revenues and operating profits for PepsiCo increased approximately 7% and 8%, respectively, over the past 12 months as consumers continued to favor PepsiCo's beverage and snack food products, even with price increases associated with high inflation. The future of PepsiCo remains bright as this core consumer goods company continues to cultivate its presence in both developed and emerging global markets:

1. According to Statista, an estimated $790 billion of non-alcohol soft drink beverages were served around the globe in 2022, and the market is expected to grow 6.1% in 2023. The global non-alcohol concentrated syrup market, which PepsiCo and Coca-Cola dominate, is expected to reach $33.8 billion by 2025, according to a report by Grand View Research, Inc. This represents an annual growth rate of

5.9% based on increasing product demand across the globe. In addition, the world's population continues to grow and is expected to increase from eight billion today to 10 billion by 2050. Over the long term, an increase in the population creates more demand for food and beverages. We can conclude that, while PepsiCo's and Coke's beverage products sold worldwide represent a large portion of the beverage market, there's a lot more market share to grab. We believe PepsiCo and Coke are positioned to become much larger in the future as emerging markets such as China and India continue to develop their middle class.

2. PepsiCo owns more than 20 brands that generate more than $1 billion a year in sales and has operations around the world. In 2022, PepsiCo's products were distributed across more than 200 countries and generated annual net revenues of more than $85 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. PepsiCo is also the largest snack-food company in the world, with a global product offering that exceeds its beverage counterpart.

PepsiCo is a resilient, adaptable, and sustainable business and should be considered "extremely valuable"—an enterprise that can grow far into the future and stand the test of time. As we addressed earlier in this letter, the secret to PepsiCo's resilience and adaptability is its flexible and impenetrable distribution system the company has built over the past century. PepsiCo's industry stronghold is its large, complex distribution system that is difficult for any competitor to duplicate. Smaller competitors wishing to enter multiple markets and develop scale with a new beverage or snack product have little choice but to make an agreement with PepsiCo for distribution and delivery of their products using PepsiCo's system.

PepsiCo's consistent brand development, product diversity, and growing global reach provides investors the ability to forecast the future with a relatively high degree of probability. It is very 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.

PepsiCo continued to increase its returns to shareholders, raising the annual dividend by 7% in 2022, from $4.30 per share to $4.60 per share. We expect PepsiCo to raise its dividend in 2023 to approximately $4.80 per share, which implies an approximate forward dividend yield of 2.65% at the year-end stock price. We also anticipate that the company will repurchase $2.5 billion of stock during the next 12 months. This action would add another 1% return to shareholders, representing a 3.65% forward pass-through yield.

In summary, PepsiCo continues to prove resilient to business downturns and an ability to adapt to 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 during tougher economic conditions, such as in 2022. We remain sanguine about future global economic growth, however, and believe that these businesses will gain further traction in upcoming years. Future growth in the European and Asian economies, augmented by further U.S. infrastructure investment, should allow these businesses to make 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—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. As globalization continues, the consolidation of businesses involved in transporting purchased goods will be a natural development, with fewer companies positioned to provide the breadth of products and services customers 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, CSX and FedEx, have comparable advantages that allow them to be resilient and adapt to industry change. 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 for the freight and overnight package sectors 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. In essence, resilience and adaptability are built into these businesses owing to their deep, impenetrable networks that are nearly irreplaceable. The "network effect" also creates an oligopoly, with just a few companies affecting most of the industry.

Although transportation businesses are capital-intensive, certain other attributes make this type of investment attractive in any economic environment. For example, 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. This cost difference becomes even more prevalent during a high inflation period, like the one we are experiencing now.

CSX Railroad

CSX is one of the country's oldest railroads, with roots in the nation's first common carrier—the Baltimore & Ohio (B&O) Railroad, 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 65,000 freight and container cars providing access to more than 70 ocean, river, and lake port terminals along the Atlantic and Gulf coasts, the Mississippi River, the Great Lakes, and the St. Lawrence Seaway. CSX also has an intermodal business that links customers to railroads via trucks and terminals.

In June 2022, CSX expanded its network by completing its acquisition of New England's Pan Am Railways, whose rail carrier subsidiaries constitute North America's largest regional railroad. Pan Am Railways, which operates a highly integrated, nearly 1,200-mile network, 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 has gained 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 2022, CSX generated approximately $14.85 billion in revenue—nearly 19% more than in 2021, while net profits increased around 27%, to nearly $4.1 billion. A portion of this year's revenue and profit increase was a result of CSX's ability to pass on fuel increases to customers through fuel surcharges. This "bump" will likely not occur in upcoming years.

The company continues to execute on its new operating model—precision-scheduled railroading, which focuses 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 recent years, improving its customer service, lowering costs, and increasing free cash flow. While we believe that most of the efficiencies

to be gained from precision-scheduled railroading have been realized, we expect moderate efficiencies to emerge at CSX in the future as revenue continues to climb while expenses remain under control.

During 2022, CSX distributed approximately $5 billion of cash to shareholders in the form of dividends (around $855 million) and share repurchases (another $4.15 billion). In 2023, we anticipate that CSX per-share earnings will remain flat, given the economic slowdown that is anticipated for the upcoming year. Nevertheless, we expect CSX to distribute an additional $4 billion to shareholders through a combined dividend and stock repurchase program. This provides shareholders with an approximate 6% 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 long-term growth of the U.S. and global economies, which will likely accelerate over the next five years because of U.S. infrastructure 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 from operating activities into cash available for shareholders. We will remain long-term owners of CSX, which occupies an important position in our portfolio.

FedEx Corp.

FedEx provides a broad portfolio of transportation, e-commerce, and business services through its collective business segments that operate under the respected FedEx brand. The organization is large and consists of a complex network through three primary business segments:

- **FedEx Express** is 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 Express represents around 50% of total FedEx revenues and 40% of its normalized operating profit. FedEx Express is the original business segment started by Fred Smith (FedEx's Founder and Executive Chairman) and is the world's largest provider of guaranteed express delivery services. FedEx Express provides same-day, overnight, and multi-day delivery services for documents, packages, and freight through a network of 87,000 ground vehicles, 684 aircraft, and approximately 77,000 drop-off locations. The bulk of FedEx Express' revenue (60%) is for time-sensitive domestic U.S. shipments of packages and freight. The remaining 40% comprises international cross-border shipments and domestic shipments within foreign countries.
- **FedEx Ground** is a leading North American provider of small-package ground delivery services. FedEx Ground represents 40% of total FedEx Corporation's revenues and 40% of the company's normalized operating profit. FedEx Ground is North America's second-largest ground transportation and package delivery company (UPS—United Parcel Service—is the largest). FedEx Ground makes residential deliveries seven days per week that are largely related to e-commerce packages involving most of the U.S. population. FedEx Ground is a complex business that operates a hub-and-spoke sorting and distribution system that consists of more than 600 facilities, including 40 hubs, in the U.S. and Canada. The FedEx Ground operation relies on third-party providers for line-haul transportation between its facilities and hubs and uses a fleet of approximately 96,000 vehicles that are owned or leased by third-party service providers for pick-ups and deliveries.
- **FedEx Freight** is a leading North American provider of less-than-truckload ("LTL") freight services across all lengths of haul. FedEx Freight offers 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 represents 10% of total revenues and approximately 20% of the company's

operating profits. Unlike the outsourced transportation model in the Ground segment, FedEx Freight primarily uses FedEx-owned trucks and FedEx employees to complete customer shipments. In contrast to the delivery of packages or documents that constitute the primary business of FedEx Express and FedEx Ground, FedEx Freight mostly transports bulkier items and pallets of goods. A recent initiative by the company is under way to make FedEx Freight the preferred line-haul provider for FedEx Ground, including use of FedEx Freight's extensive intermodal relationships with major U.S. railroads to move Ground shipments. This initiative should drive material cost savings across FedEx as the company finds ways to integrate its three business segments.

Through a complex global transportation, information technology, and retail network, we believe FedEx is uniquely positioned to connect customers and consumers throughout the world. The following large trends provide FedEx an opportunity for long-term expansion and unprecedented integration of customer goods, services, and information:

- **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 its business-to-business revenues, residential e-commerce is the fastest-growing delivery service sector 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 increasingly sourcing and selling globally. With customers in more than 220 countries and territories, FedEx serves as a crucial part of 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.

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 nearly 100% of the global economy.

Over approximately four years since our initial purchase, ending with FedEx's fiscal year-end of May 2022, the company's revenues increased at a compounded annual growth rate of 9.3%, reaching $93.5 billion in its fiscal year 2022. Over the same four-year period, adjusted earnings per share grew at a compounded annual growth rate of 9.5%. During fiscal year ending May 2023, FedEx's revenues are expected to be relatively flat at around $93 billion, but per-share profits are expected to decline to $13.60 due to the slowing global economy—thus the recent stock price decline.

We stated that FedEx is a capital-intensive, economically sensitive business and that, despite FedEx's strong competitive advantages, its business segments are highly cyclical. We expect FedEx's revenues to continue to grow and that its margins will return to normal as the economy recovers. We remain 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 of this company's fixed network will improve profitability and returns on capital in the future, adding value to FedEx and shareholders.

FedEx Corp. is expected to earn $3.5 billion of net income in its fiscal year ending May 2023, or an adjusted $13.60 per share—a 34% year-over-year decline from the $20.63 adjusted earnings per share in the fiscal year ending May 2022. We expect combined per-share earnings to increase approximately 25% in the fiscal year ending May 2024, to $17.00 per share. When comparing forward earnings to the company's year-end stock

price of $173 per share, investors are receiving an entry earnings yield of 9.8% on their FedEx investment—and we expect per-share earnings to grow over the next five years, especially given the company's strategy to take advantage of the growing interconnected global economy and to improve its profit margins by lowering cost structure and reducing capital intensity in the future.

TECHNOLOGY & COMMUNICATION GROUP

Every 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 2022, the technology and communication sector once again contended with breakneck change as device power continued to grow, cloud computing gained further traction, and social media interaction and individualized e-tailing continued to flourish. Furthermore, technological advancements enabled greater adoption of artificial intelligence (AI) in various market sectors.

The inherent disruption and warp-speed change within the technology and communication sector continue to make it extremely difficult to determine which companies will succeed or fail. Around 15 years ago, Steve Jobs introduced the iPhone to the world, and this single device allowed Apple to become a primary technology disrupter. Since then, the exponential gains achieved through the smartphone technology cycle have passed, with market share-hungry competitors developing "copycat" Apple products. However, Apple continues to be a leading technological innovator, introducing additional devices and services to the consumer.

Amazon remains 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. Microsoft is also a leading cloud service provider to businesses and is securing a large share of the market as corporations integrate their computing requirements.

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. Which companies gain competitive control in the evolving technology and communication landscape 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 arena. 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. We continue to seek resilient and adaptable businesses in a fast-paced industry that experiences ongoing disruption. Even with this objective, it is difficult to point to a single specific company in this industry that could be placed in the "guaranteed invaluable business basket"—too 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, Alphabet (Google), and Meta Platforms (Facebook).

Microsoft

Microsoft has had to be resilient and adaptable through several disruptions since its debut as a public company in 1986. Over the past 37 years, Microsoft has faced challenging times with a barrage of competition, the U.S. government's monopoly lawsuit, and a rapidly changing technology landscape.

Ten years ago, Microsoft was literally written off by investors as a dinosaur. The company was struggling with its primary product—Windows—as consumers were quickly moving toward companies that offered full hardware and software integration across all their devices (such as 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—entering 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.

According to Grand View Research, the cloud computing market will increase at a compounded annual growth rate of 15.7% until at least 2030. Microsoft, currently with a 21% share of the cloud computing market, is highly focused on growing its cloud computing platform, Azure. We expect Microsoft to achieve significant gains in this area over the next decade.

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 through a subscription service. The infrastructure that supports cloud computing comprises large data centers (i.e., server farms) that are owned and operated by companies such as Amazon (34% market share), Microsoft (21% market share), and Google (11% market share). 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 had another year of sensational business results in 2022, growing its year-over-year revenues and operating profits by approximately 18%. The current slowdown of the global economy is leading to less corporate spending, however, and Microsoft will likely be impacted by an economic downturn during 2023. Although we remain enthusiastic about the company's prospects, during the next year we expect Microsoft's revenue to grow by approximately 7% while profits grow approximately 3% to 4%. Adjusted earnings are expected to grow approximately 4.5% to $9.60 per share in Microsoft's fiscal year-end June 2023 (the higher increase in per-share earnings is due to expected share buybacks). During the current fiscal year, Microsoft will generate approximately $65 billion of owner earnings and will return a large amount of this cash to shareholders through net share repurchases of approximately $35 billion and $20 billion of dividends (an approximate 3% 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.

Alphabet (Google)

Alphabet, the parent company of Google, is a multinational technology conglomerate holding company with a growing portfolio of businesses that span technology industries including software applications, life sciences, enterprise solutions, hardware products, investment capital, and web-based 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 through Google Docs and 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 (which currently holds more than 70% global market share), 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.

Over the past five years, we have made a significant investment in Alphabet 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 pivoted to Alphabet. We are pleased that we made this adjustment and will maintain a significant position in Alphabet, which we consider to be a long-term strategic holding in our portfolio.

The dramatic changes in the technology industry over the past 15 years includes the advent of cloud computing, which has enabled the emergence of cognitive computing and artificial intelligence (AI). With the exponential rise in cloud computing, massive amounts of data are housed in interconnected computers around the world, and companies seek to transform this information into useful knowledge through various applications and data analytics capabilities. Today's digital intelligence is based on massive data mining and analysis, and increasingly sophisticated cognitive computing capabilities are gaining prominence.

Cognitive computing—the simulation of human thought processes in computerized models—allows for computers to systematically learn—and even teach, to an extent. As technology giants such as Alphabet, Microsoft, and Amazon work diligently to make advanced computer learning a reality in this new environment, AI will become a reality. We believe that Alphabet has a tremendous opportunity to penetrate the growing AI technology segment as cloud computing and cognitive computing capabilities further develop. Alphabet has been making major acquisitions and investing in the cloud space to compete for this growing market and now has an 11% share of the cloud computing 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 products and services to customers.

So why does Alphabet have a tremendous opportunity in the AI space? Cloud service providers such as Alphabet develop algorithms that allow their computers to learn as data continually moves through their networks. 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 consistently compiled Google data gives Alphabet 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 ongoing information gathered acts as a catalyst to propel these businesses to develop and 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 advantage—the information it gathers on an ongoing basis, along with knowledge provided 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 search experience 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.

Obviously, the winners in the AI world will be companies that have the greatest amount of usage and data flowing through their computers, and we cannot think of any company on the planet that has more widespread usage by individuals than Alphabet.

Alphabet is an extremely profitable company that produced adjusted earnings of $67 billion in 2022, or $5.16 adjusted earnings per share. After last year's knockout performance, with Alphabet's earnings nearly doubling in 12 months, this year's results were more tepid, with per-share adjusted earnings growing 3%. In 2023, Alphabet is expected to grow its per-share adjusted earnings to approximately $5.80 per-share, with owner earnings reaching approximately $65 billion. With Alphabet's current market capitalization of approximately $1.145 trillion and removing net cash after debt cash of approximately $100 billion, a buyer of Google is obtaining an approximate 6.2% forward owner-earnings yield that is growing at approximately 14% per year. At the current price, Alphabet continues to provide us with an opportunity to own a great collection of promising enterprises that have high growth potential through expanding service interconnectivity.

Meta Platforms (Facebook)

Last year, we introduced our latest investment: Meta Platforms (formerly Facebook). Not long after our purchase, the price of Meta's stock tumbled, and it continued to sink as the year progressed. When this happens, an investor obviously questions the acquisition. We realize this position is on everyone's' mind and, given that our allocation of capital to this business was rather large, will detail our thoughts about it.

We will examine three aspects of the Meta purchase from the perspective of the company's potential long-term sustainability and value:

1. Bad investment timing (best case)
2. Miscalculating Meta's value at the time of purchase
3. Failing to recognize that Meta may be facing a change that could permanently destroy value (worst case)

Was Our Timing Off?

The "timing" of this investment was obviously poor, given the nearly 65% deterioration in Meta's price during 2022. We might be tempted to take solace in the fact that the price of most social media platform businesses with advertising-based models also deteriorated this year—Snapchat was down 81%, Shopify was down 75%, and Spotify was down 66%—but no matter how you try to account for it, a timing slip is painful. If the price falloff is due to timing, however, this can be rectified with time.

Did We Miscalculate Meta's Value?

It's possible that we miscalculated Meta's value, and that it was not worth what we paid for it at the time. How much of a miscalculation is a good question to dig into, keeping in mind that the valuation of any business is always a range, as opposed to an exact dollar amount.

In last year's letter, we compared how Meta traded at a discount relative to the overall market. At the time, the S&P 500 index was trading at around 20x 2022's expected earnings, depending on one's estimate. With projected earnings of more than $14 per share in 2022 and a long-term growing franchise, Meta was trading at a very similar valuation multiple to the market, including the extra cash sitting on its balance sheet. In other words: Even though Meta was a far-above-average company when measured against every business metric imaginable, in 2022, investors were not willing to pay a dollar more for its fast, growing earnings than what they would pay for the composite of all major U.S. companies.

At the end of 2022 (with "2020 hindsight"), we were reminded of an excerpt from a 1929 *New York Times* article about Albert Einstein's view of relativity:

> *When you sit with a nice girl for two hours you may think it's only a minute, but when you sit on a hot stove for a minute you think it's two hours. That's relativity.*

Clearly, we have been sitting on a hot stove with Meta over the past year, and it has felt like an eternity.

Putting aside any relative comparisons: It's possible that we made a miscalculation in our valuation of Meta. Meta's financial performance of previous years reflected a business that was experiencing high growth and pre-tax profit margins that hovered between 35%–40%. Meta's recent large spending of $15 billion per year to gain a toehold in the emerging metaverse, coupled with its consistent large investment in data centers and emerging artificial intelligence, led to the company spending around 30% of revenue on research and development. (It is worth noting that Meta's R&D investment as a percentage of revenue is more than twice that of Alphabet and Microsoft.) This outsize spending led to a profit margin compression at Meta, where pre-tax profit margins are now around 25%—approximately 33% less than before. Obviously, Meta's enormous incremental spending is negatively impacting current profits and cash available for shareholders, leading to a lower value and subsequent decline in stock price these past 12 months.

The intrinsic value of any business is correlated to the discounted value of the cash that can be distributed to owners during its remaining life. This is the only true way to value a business asset. Meta continues to deliver a high level of free cash flow that is distributable to shareholders, despite spending enormous sums of money to build out its business to accommodate future growth. Calculating 33% less cash per year than previously expected between now and a remaining business life commensurately lowers its value as well. If Meta continues to spend enormous sums of cash on future projects, creating an essentially permanent state whereby 33% less cash can be distributed to its owners between now and kingdom come, then the calculated value of Meta will be 33% (or more) less than what was originally anticipated.

In summary, unless Meta changes its spending pattern, we overpaid for the business, and it will take time for it to reach our originally calculated value. Meta has announced a slowdown in its spending as well as layoffs that will impact 11,000 employees. We shall see how this situation progresses and whether cash available to shareholders is positively recalibrated in the future based on the company's cost-reduction actions. In the meantime, investors have reacted negatively to this large spending program and have driven down Meta's stock price to a point where the company's value represents nearly a 50% discount to our adjusted calculation of intrinsic value. The current low valuation by the market seems extreme, and we do not intend to sell Meta at its current price.

Did we Fail to Recognize Changes Portending a Permanent Destruction of Meta's Value?

In the worst case, was this a "Kodak moment"—a failure to recognize that Meta is facing a change that may permanently destroy its value?

Last year, we mentioned various attributes of Meta that attracted our attention, such as the company's dominant presence in the digital advertising marketplace (along with Google). According to a recent eMarketer report, Meta and Google collectively controlled around 50% of digital ad spend in the U.S. during 2022 (Google has an approximately 27% share, while Meta has an approximately 23% share.) Although their aggregate share of U.S. digital ad spend is down from 53.8% since 2020 due to new entrants in the digital ad space, such as Amazon, Meta and Google are forecasted to maintain a 45% to 48% combined share of digital ad spend within the U.S. for the next few years. Although the Google/Meta duopoly share of total U.S. digital ad spend is slightly declining over time, we should remember that, according to eMarketer research, global digital ad spend (in which Meta and Google also participate) is expected to grow from $575 billion in 2022 to $850 billion by 2026—an approximately 11% annual increase.

Our conclusion here is that Meta (and Google) will be able to increase revenues through their participation in the global growth of digital advertising, despite losing market share to new entrants such as Amazon and TikTok that have been grabbing advertising dollars. In hindsight, it is also important to note that Meta's growth in digital advertising was pervasive the past few years, generating $115 billion in revenue in 2021, up 37% from 2020, on top of being up 22% over 2019. Due to the slowdown in digital ad spend and increased competition this past year, Meta will report digital advertising revenue of $113 billion in 2022, down approximately 2%.

Is Meta's user base eroding? In last year's letter, we mentioned that 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. During 2022, these numbers increased. The number of people accessing one of Meta's products each day grew to more than 2.9 billion, while another 800 million log in at least once per month, for a total user base that now exceeds 3.7 billion, representing approximately two-thirds of the planet's potential social media users.

Concluding Thoughts

Given these facts, we do not foresee a cataclysmic end to Meta's social media business, and we don't believe that Meta is the next Kodak. We do, however, see obstacles that the company must overcome that will require it to be resilient and adapt to a changing social media marketplace. Among Meta's current challenges that investors should be aware of:

1. **The interaction between users and social media platforms has changed over the past few years.** Social media participants have largely moved from posting text and pictures on their profiles to posting videos (i.e., Facebook and Instagram Reels). The movement from a static to dynamic interface between users has altered advertising on social media platforms. As a result, advertisers and social media platforms are figuring out the most effective method of attracting users via their use of video. In other words, in many cases, the results from advertising videos placed alongside users' video postings have not been as effective as the previous static advertisements sharing space with users' text and picture postings. Meta and other social platforms need to better understand how to increase engagement between users and advertisers in a video-dominated environment, and advertisers need to figure out the type of video ads that work on social media sites to engage users as well.

   It is our assessment that Meta has a unique competitive advantage in this evolving market. The company's set of social media properties (Facebook, Instagram, and WhatsApp) will naturally allow Meta to further connect businesses and consumers as self-driven video content produced by individuals and small businesses will increase and augment traditional static content.

2. **The impact of Apple's 2021 privacy setting update on social media platforms.** This Apple system update introduced App Tracking Transparency, which requires applications to ask users permission for tracking their activity across apps and websites owned by other companies. This led to many individuals opting out of having their activity tracked, which impacted all social media apps from providing "targeted ads" to users based on a previous ability to track their activity. As a result, advertisers had to spend more money on social media sites to attract individuals as advertising became more or less hit or miss. All social media companies were affected by this change, but as the largest social media company, Meta was impacted the most. In response, Meta has made agreements with other providers for user data-sharing where permissible and has altered its algorithms to provide better-targeted ads for advertisers. Nevertheless, this remains a work in progress and is taking time.

3. **Meta needs to aggressively expand its social media business segments beyond individuals, to include corporations.** Through its product called "Workplace," which enhances organizational communication, Meta is in an unprecedented position to provide large organizations with an exceptional private intranet community. The ability for an organization to connect, collaborate, and exchange knowledge instantaneously through Meta's Workplace product will lead to enhanced productivity and increased speed of innovation for many companies. According to the Workplace website, Meta's Workplace product has more than seven million users, including the recent addition of 1.9 million users from McDonald's Corporation. McDonald's is deploying Workplace to company-owned restaurants and offering the product to participating franchisee restaurants across global markets. Workplace enables employee and franchise engagement and support, information-sharing and feedback, training video deployment, and employee and franchise performance recognition.

We believe that a product like Workplace could have significant uptake by organizations worldwide, with corporations becoming entrenched in such an ecosystem in the future. Workplace application could expand to include additional employment-related issues, such as connecting healthcare providers to manage employee health and investment consultants to manage retirement benefits. As deep roots develop in a Workplace ecosystem, this product will serve as a future annuity to Meta, offering large corporations cloud services, data analytics, and AI for effective decision-making throughout their organizations. In addition, with emerging data analytics and artificial intelligence technology, Meta would be positioned to provide a unique capability to match suppliers to corporations and assist in inventory management, logistics, and the development of an overall community of partnerships.

In summary, an emphasis on creating a large business community network through Workplace would permanently cement Meta's place within the global business ecosystem. It would also create an annuitized revenue stream through business subscriptions that would complement the core Meta consumer applications that are highly reliant on advertising and subject to ongoing competition.

4. **Social media platforms will evolve in the future to include augmented reality (AR) and virtual reality (VR).** There has been a lot of hype about Meta's name change and pursuit of a "metaverse" immersive virtual world. Some clarification about the metaverse and its future is needed here. The virtual world envisioned by most people is created through virtual reality (VR) technology. But there is more to the metaverse than VR, including augmented reality (AR). While VR creates an immersive "virtual environment," AR augments a "real-world" scene. In essence, VR is 75% virtual, while AR is only 25% virtual. VR requires a headset device, while AR does not. VR users move in a completely fictional world, while AR users are in contact with the real world.

   What does all this mean? The metaverse as a mechanism for individuals to seamlessly connect in a virtual world is going to take some time, while the capabilities for individuals to connect in an augmented world will be here within the next five to seven years. Think of connecting immediately with a friend or viewing driving directions through the corner of your glasses, as opposed to looking down at your phone. Or think of a surgeon being able to use augmented reality glasses to connect remotely with another surgeon to guide him through a complex procedure—while they're both viewing the same patient. These concepts are part of a metaverse that is just around the corner, and Meta (along with organizations such as Apple and Google) is currently working on devices to deliver these capabilities.

   The future of the metaverse is an area that has yet to be fully defined, but we can all see its importance as the ability to interact socially in a multidimensional setting emerges. Meta's desire to control the major platform in which the metaverse exists —before another organization such as Apple gets control—is understandable. However, we recognize that the metaverse envisioned by most people will take years to fully develop. A robust VR environment will require trillions of dollars of infrastructure investment from many different participants, including improved broadband capability and new computing power to enable many individuals to connect simultaneously. Ultimately, the architecture for a VR metaverse provided by players such as Meta will naturally evolve in concert with infrastructure development—for example, 6G and quantum computing.

As stated in last year's letter, perhaps investors anticipate other issues that could further impact Meta's profits over time, such as future regulatory examination and controls. The company has been barraged with congressional investigations, *Wall Street Journal* reports, and *60 Minutes* coverage about its platforms. Much of this coverage is about a negative influence on young adults from social media in general. From cyberbullying, inappropriate content, misinformation (fake news), and social media addiction, both young and older adults are contending with self-image issues and developing social anxiety through extreme usage. Given that social media platforms will not be going away, it is highly likely that the U.S. government will (and should) take action to create "rules of the road" as well as restrictions on social media's activities in the future.

We are on board with the establishment of regulatory guardrails for all social media companies, similar to establishment of regulations over the past century for television, radio, movies, etc.

Meta already has tremendous scale in the media ecosystem that the government (and Meta's competitors) would find difficult to duplicate. Meta employs more than 15,000 content moderators who, working in tandem with highly refined artificial intelligence servers, moderate text, video, links, updates, photos, and file uploads of nearly half the world's adult population. This is an enormous task, and achieving meaningful control over any social media ecosystem without regulations and standards in place is essentially impossible. While Meta's failures are criticized (fairly) at times, we ask ourselves: If not Meta, who will take on this task? Who else has the scale, the experience—even the incentive—to do the job? Mass online social sharing is here to stay; the only question is how it will be managed by social media platforms, governments, parents, and individual users.

On the other side of the fence is the opposite complaint: Meta is accused of *too much censorship*. Managing social media content 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. Eventually, social media engagement rules will need to be established by governments throughout the world and adhered to by social media participants in each respective country.

We do believe that Meta cares deeply about content moderation and that it is currently a victim of its own success—its ubiquity is so overwhelming, and its products so conducive to human proclivities (good as well as bad), that problems are inevitable. But we also believe that Meta is the only company with the scale, skill, incentive, and technical talent to handle the problems inherent in a social media platform, and so we believe that its competitive position is strong—and here to stay.

FINANCIAL SERVICES GROUP

Berkshire Hathaway

Berkshire Hathaway had a very good year in 2022, despite the downdraft experienced by most businesses. Berkshire's unmatched diversity, strength, and predictability act as ballast that allows the enterprise to be resilient and adapt to changing economic conditions.

Warren Buffett's holding company is extremely diverse, with 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 (an approximately $300 billion equity portfolio, of which around 40% is Apple stock), and dozens of smaller services and industrial businesses that collectively make up another large portion of Berkshire's value. Berkshire's total assets are valued at approximately $900 billion, and the company holds more than $450 billion of shareholders' equity—the largest for any publicly traded corporation in the world.

Although Berkshire's financial performance this year was temporarily impacted due to a declining stock portfolio, as well as slowing business activity in its owned businesses, the company put capital to work that will enhance future returns. Warren Buffett purchased more than $50 billion of equities in 2022, including expanded positions in energy through additional commitments of approximately $20 billion to Chevron and $10 billion to Occidental Petroleum. Warren Buffett first invested $10 billion in Occidental in 2019 to help fund its purchase of Anadarko Petroleum. At the time, Berkshire received 100,000 shares of preferred stock, which pays an annual dividend of 8% ($800 million per year) and warrants to buy almost 84 million shares at $59.624 per share. As a result of Berkshire's large cumulative position in Occidental Petroleum, the U.S. energy regulator gave Berkshire permission to purchase up to 50% of Occidental Petroleum.

Despite adding around $50 billion to Berkshire's equity portfolio, the company maintains approximately $110 billion of cash and cash equivalents on its balance sheet. Dormant cash was earning nearly zero at the beginning of the year, however, with short-term interest rates rising to 4.5%, Berkshire's annual earnings can

increase by more than $3 billion as a large portion of this money is now being put to work via purchases of risk-free, shorter-term U.S. Treasury bonds.

At the end of 2022, Berkshire reported a decrease in per-share book value, down 10% over the preceding 12 months. During 2022, Berkshire was able to repurchase around $6 billion of stock, reducing its share count slightly less than 1%. What is more amazing about Berkshire Hathaway is the fact that the company's tangible book per share has grown an amazing 11% per year over the past five years—this includes Berkshire's equity holdings, which have been marked down with the recent market decline, as well as the company's repurchase of $70 billion of stock over the past 60 months. Warren Buffett continues to create tremendous shareholder value through the prudent allocation of capital, enhancing shareholders' interest in owning this wonderful company.

Moving forward, it is our opinion that Berkshire is capable of growing its current enterprise between 3%–4% per year from the development of its underlying business, while share repurchases and/or any future acquisitions (both marketable securities and whole businesses) should add at least another 5% per year—for a total return of 8%–9% per year over the next five years. If Berkshire's company valuation holds steady relative to its growing book value, shareholders should receive similar returns. Of course, this is a guesstimate based on the facts we have available today, and we will continue to update our understanding of the company's position as new information comes to light.

In summary, Berkshire remains a fairly valued investment growing at an above-average rate (on a per-share basis). It is an allocation in which we have the lowest chance of permanent loss compared to any other asset we currently own—or could contemplate owning in today's market.

Wells Fargo

As discussed over the past few years in our annual reports, the main issue Wells Fargo confronts is the continued compression of interest rate spreads (i.e., net interest margin, or NIM), which is an all-important ingredient for bank shareholders. The greater the spread between the money earned on invested bank assets vs. the cost of these same funds, the more money the bank makes. Last year, we reported how Wells Fargo's NIM in the first nine months was a mere 2.03%. At year-end 2021, Wells' NIM finished at a multi-year low of 2.05%. This compared to 2.28% and 2.73% in the years 2020 and 2019, respectively. A compression in any bank's NIM leads to a compression in bank earnings and, ultimately, value. The good news, now that interest rates have risen throughout 2022, is that Wells Fargo's NIM jumped to 2.46% in the first nine months of 2022 and rose to 2.63% at year-end—we are on an upswing.

To appreciate the impact of the NIM on a bank's earnings, consider that the difference between a 2.0% and 2.5% margin on Wells Fargo's $1.725 trillion in interest-earning assets is around $8.6 billion per year pre-tax—all of which would be incremental profit to the company after paying taxes. Of course, there is more to a large bank such as Wells' earnings equation than their net interest margin. A bank's noninterest income and expenses are also important, and these were impacted by the slowdown in 2022. For example, deal activity slowed, which negatively impacted advisory fees, and mortgage banking fees decreased significantly as mortgage activity dropped due to rising interest rates.

A final consideration: Wells Fargo remains in the crosshairs of past regulatory issues, and the company needs to finish dealing with these ongoing challenges. Progress has been slower than we'd anticipated on this front, delayed in part by COVID-19 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. Nevertheless, we are confident that the organization is moving toward the tail end of its regulatory cleanup process, and we are hopeful that it will be out of the regulatory woodshed within the next few years. At that point, Wells can grow again. To say the least, it has been a long road for Wells dealing with the banking regulatory authorities, who have been harsh in their use of Wells to emphasize to other banking industry participants how to deal fairly with consumers.

We will remain patient during Wells Fargo's challenges. The core metrics that create bank profitability remain solidly in place at Wells. The bank has maintained its massive deposit franchise (consumers have not left the bank), and the company has the capability to grow in the future, adding value to shareholders in the upcoming years.

In the meantime, Wells Fargo continues to buy back its own shares with the excess capital released by its restricted growth. During 2022, the company repurchased approximately 128 million shares, which represents approximately 3.25% of outstanding shares. At the same time, Wells continues to pay dividends to shareholders equal to 2.9% of the company's year-end share price. Shareholders are receiving a total pass-through yield on their investment in Wells that exceeds 6%.

In summary, we anticipate that Wells Fargo will clear up its regulatory challenges over the next few years and will continue to reduce costs. These actions, coupled with an ongoing rebound in Wells' NIM, should allow the bank to increase profits. With a mix of higher profits, a much-reduced cost base, and lower share count, Wells is positioned for a significant increase in earnings per share and, potentially, a higher stock price. As long as these dynamics are in play and the stock price remains static, 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 essentially completed our investment in this company with additional purchases during 2016—though we continue to add to our American Express holding when we believe the difference between the company's stock price and intrinsic value becomes wide. Although the pandemic severely curtailed travel in 2020, the revitalization of travel and consumer spending in the back half of 2021 and throughout 2022 produced levels of revenues that are now significantly higher than pre-pandemic levels. Similarly, Amex's per-share profits in 2022 exceeded pre-pandemic levels, and we expect the company's revenues and per-share profits to continue their upward trajectory in the coming years.

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. However, the company's full range of products and services also 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. Also, 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 include 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 as a way to optimally serve its base of corporate clients that require effective management of large travel and entertainment budgets. The American Express system collects all travel and entertainment expenses information, which positions 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 are also 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 the 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 2022, American Express experienced an approximate 25% increase in revenue, to $52.9 billion. This large revenue jump was due in part to pent-up demand as customers felt more comfortable traveling amid COVID-19's negative impact that started in 2020. Another factor that lent an unexpected boost to Amex's revenue increase: Inflation. As we explained earlier, Amex employs a "spend-centric" business model, whereby the company largely makes its money based on the percentage of money customers spend, as opposed to their number of transactions. When prices for food at restaurants, entertainment, and travel increase with inflation, Amex receives the same percentage of a larger spend, which increases revenues. Amex is essentially an inflation-protected business—when inflation leads to price increases, the company's revenues increase as well. Too much inflation does eventually lead to lower consumer spending and higher consumer credit losses, however, which can offset this otherwise beneficial situation.

American Express produced around $7.5 billion of net earnings in 2022, or $9.95 per share—representing essentially flat earnings per share compared to 2021. (The reason Amex's year-over-year per-share earnings were relatively flat was due to the company in 2021 reversing loss provisions taken in 2020 for expected credit write-offs during the pandemic. These losses in 2020 were ultimately not realized, necessitating a reversal in 2021 that led to higher reported profits last year.) During 2022, the company maintained its dividend, distributing more than $1.5 billion to shareholders. American Express also continued its stock repurchase program, buying back more than $3.3 billion of stock during the past 12 months—creating value for long-term shareholders. Overall, in 2022, Amex's business continued to grow in a difficult economic environment, giving us confidence that American Express will continue strengthening 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—both had a tough year in 2022, with consumers reducing their spending in an inflationary environment. Unfortunately, given the continued economic slowdown expected in 2023, we expect revenue and earnings for our two retailers to remain static next year. Nevertheless, we anticipate continued growth for our retail group in the future and expect CarMax and Home Depot to increase both earnings and market share in upcoming years. The long-term expanding intrinsic business value of CarMax and Home Depot will ultimately be reflected in their stock prices, despite their temporary setback in 2022. We plan to remain owners of these great retail franchises, confident about their growth in intrinsic value as they continue to execute on the four essential elements of retail success:

1. **Excellent customer service:** If people 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 many other retailers have gone through bankruptcy, and retailers like Bed Bath & Beyond, Carvana, and Rite Aid are currently struggling in one or more of these areas, resulting in an ongoing deterioration in sales and/or profitability.

Our interest is in large, industry-specific retailers that gain economic value as their industries consolidate over the long term, and 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 segments. Despite tough competition, these retailers continue to gain ground in their difficult respective retail realms and will likely gain additional ground in upcoming years. We have not changed our view: Our retail enterprises are extremely valuable, and it is very difficult for new competitors (including Amazon) to gain a foothold in these specialized retail segments that require substantial networked infrastructure and real estate development.

CarMax

In last year's letter, we cited how CarMax had a robust fiscal year 2021, when revenues soared 68% and net profits surged approximately 54%. There was a reason for these tremendous numbers: 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 extraordinary levels. Used-car values rose 50% higher in 2021 compared to 2020.

During 2022, the story for CarMax reversed: The business faced a high-inflation environment that took a slight toll on sales and had a large negative impact on profitability. By its fiscal year-end in February 2023, CarMax's used-car sales are expected to be down 4%–5% over the previous year, and profits are expected to have fallen around 60%, from $1.15 billion to $460 million. A primary cause of this profit decline is a significant increase in CarMax's sales and administrative expenses, which rose about 12.5% over the previous year.

Despite the temporary setback of the past year, CarMax continues to focus on building its long-term competitive position in the used-car marketplace. The company continues to gain market share in the 0-10 year used car market and has transitioned to an "omni-channel" program, whereby CarMax customers coast to coast have the ability to complete their transactions fully online if they wish. CarMax is the only used-car retailer with a full physical as well as digital footprint and is positioned to continue growing its share of the large, fragmented used-car trade.

CarMax is also more resilient and able to adapt to a changing market more rapidly than its competitors (specifically Carvana), which are also contending with the tremendous pressure wrought by the downturn. Why? CarMax possesses a large data advantage as an intangible asset. For example, CarMax's sales and appraisal data goes back to its founding in 1993, and this data cannot be purchased by a competitor. CarMax uses this data to arm its car buyers with the best information on vehicle auction pricing and appraisal value.

CarMax also applies this data to develop a national pricing algorithm, which helps the company retail more than 99% of the vehicles offered through its stores. It is our opinion that CarMax's data advantage provides the company with higher profitability and greater market penetration compared to its competitors. CarMax's "data edge" has helped the company maintain its gross profit per retail unit at more than $2,200, despite gyrations in the average selling price per vehicle. We also regard the vehicle purchasing insight provided by CarMax's data edge as an additional huge asset. Fundamentally, CarMax has a cost advantage because its data sourcing enables the company to both optimally pay for inventory and optimally price vehicles for sale on its owned lots.

Additional competitive differentiators for CarMax are its proprietary information systems and its captive finance arm. Most auto dealers use prepackaged software that is geared toward the multifaceted operation of a franchise dealer. CarMax developed its own dealer management system software in the 1990s and is the only large dealer that uses dealer management system software that is tailored to a specific used-vehicle retailer. This allows CarMax to leverage its technological capabilities to test finance-based shopping enhancements, such as enabling customers to prequalify for a loan without impacting their credit scores. In contrast to other used-auto dealers, the company also has the capability to offer personalized loan terms from multiple lenders for any vehicle.

CarMax remains ambitious and continues to develop its competitive edge. The company's goal by the end of calendar year 2025 is to sell two million vehicles through its retail and wholesale channels and to grow its national market share from around 4.2% to 5% of used cars that are up to 10 years old. Given the company's current position, we believe this goal is achievable.

CarMax will earn approximately $2.85 per share in its fiscal year ending February 2023—59% less than the previous year. We expect a rebound in profitability in the upcoming year ending February 2024, however, with CarMax expected to earn $3.10 per share. Although the company has temporarily slowed down its share repurchase program, we expect that CarMax will maintain a long-term program whereby the company annually repurchases between 3%-4% of its outstanding shares. CarMax currently has a 240-unit store base, and the growth in its wholesale and captive finance units, along with the growth of its online consumer channel, positions the company to commensurately grow its per-share earnings and per-share intrinsic value in the foreseeable future. With the anticipated growth in sales and the company achieving normalized profit margins, we believe CarMax is trading at a meaningful discount to its intrinsic value. We remain patient and optimistic shareholders.

Home Depot

Home Depot had a very good year given a difficult economic environment and flexed its resilience and ability to adapt to challenging conditions. Home Depot had followed a robust 2020, when the company posted nearly a 20% increase in sales, with another outstanding year in 2021, when it grew revenues an additional 14%, reaching $150 billion in annual revenue. One would have expected that in 2022, after being hit with inflation and a consumer spending slowdown, Home Depot would show a significant sales decline, in line with other retailers. Home Depot defied the odds this past year and actually increased its sales an additional 4%. Profitability followed this upward trend, with annual net profits also increasing 4%—reaching more than $17 billion in 2022. Given Home Depot's ongoing share repurchase program, per-share earnings grew 7.5%, from $15.53 to $16.70 per share in the past 12 months.

Home Depot continues to benefit from a number of trends in its sector and in the country. According to Statista, home improvement spending in the U.S. is around $550 billion per year and has increased over time at a steady rate of 4%–5% annually—and this expansion is expected to continue. 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., collectively accounting for nearly $255 billion of revenue in the U.S. home improvement sector in 2022. Home Depot and Lowes continue to grow their respective market shares, and it wouldn't surprise us if those shares continue to increase as Home Depot and Lowe's implement

contractor-friendly “Pro” programs that seek to grab business 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 homes and buildings in shape.

Home Depot’s competitive advantages serve as a wide and deep moat around its retail castle. 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 believe Home Depot has a long and bright future ahead for its unique business. Nevertheless, investors should keep an eye on several issues:

1. 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 just the U.S. home improvement market, along with Lowe’s and smaller players like Tractor Supply and Floor & Decor.
2. Home Depot operates at the whims of the housing market, which is currently impacted by higher interest rates that have led to higher mortgage rates for home buyers. As a result, housing starts are expected to decrease 18% year over year in 2023, to 1.27 million units—which would be level with new residential construction in 2018-2019. Despite this temporary setback, we expect housing starts to rebound in 2024 as inflation moderates, interest rates and mortgage rates decline, and home prices become more affordable. We then see home price appreciation returning to a long-run annual increase of 3%-4% and repair/remodel spending normalizing at a 5% annual rate of growth.

Over the previous few years, Home Depot’s market valuation increased significantly alongside its robust revenue and profit growth. The recent economic slowdown negatively impacted Home Depot’s valuation this past year, along with its stock price. Although investors should temper any expectations of Home Depot repeating the significant growth the company experienced during the first years of the pandemic, when home improvement projects proliferated during the stay-at-home era, we believe Home Depot’s substantial competitive advantages, continued growth, excellent management, and “fair” valuation will provide investors fair returns over time.

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 as content producers continue to migrate to direct-to-consumer “streaming” and as consumers “cut the cord” and leave traditional cable providers. The vast and growing number of platforms available for content distribution and the multiple channels through which consumers can access entertainment make it paramount for media companies to 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. An ever-accelerating transfer of advertising revenues into emerging new media companies continues, 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 few years, 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 continuously 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 remains the one media 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. When the company re-launches its classic productions in updated formats—such as the CD format of the past, the streaming service (Disney+) of today, and 3D virtual reality in the future—the company 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, adapted for viewing on whatever happens to be the channel or medium of that future. 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.

The Walt Disney Company had a very challenging year in 2022—media companies vied for consumers' attention by delivering (and spending heavily on) original streaming content, and Disney was no exception. While the company's direct-to-consumer initiatives through Disney+, Hulu, and ESPN are major drivers for the company's long-term growth, the cost of developing leadership in a new direct-to-consumer channel requires heavy investment. Although Disney's streaming service subscriber base will grow throughout the world in the future, and consumers will continue to benefit from new content created at Disney (along with access to the company's deep franchise library of classic content), Disney's current development costs and investment in streaming services is large, impacting its profits.

Disney's CEO, Bob Chapek, was thought to be focused on streaming development to the detriment of the company's other businesses, including creative content and parks. In a surprise move in November 2022, Disney's board replaced Bob Chapek and rehired Bob Iger, who had retired less than 12 months earlier. The return of Bob Iger as Disney's CEO is not likely to derail the company's direct-to-consumer streaming focus, but we believe the company's ambitions to aggressively invest and scale Disney+ will be scaled back a bit to improve profitability. In his first few days on the job, Mr. Iger stated that he will place a high emphasis on Disney's creative core. In line with Mr. Iger's past leadership at Disney, we expect the company to maintain a balanced focus: Expanding its invaluable library of content, broadening its distribution network, and embracing new technologies that complement and enhance the Disney experience.

In its fiscal year 2023, we expect Disney to grow revenues by approximately 8.5%, approaching $91 billion. Annual profits will likely increase significantly, from $4.7 billion to $7.2 billion, as the company focuses on increasing its bottom line. Given its renewed attention to profitability and balanced investment in its future, we remain enthusiastic long-term shareholders of Disney. We 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 15.4% loss in 2022—on top of a slight 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 still not applying a business perspective, despite the rising interest rate environment. For example, putting aside tax implications, if we purchased a 30-year U.S. Treasury bond today at an approximate 4% annual yield (vs. a 2.0% yield last year) and chose to reinvest the coupon payments into those same bonds at par, it would take 18 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 4% 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 4% on a 30-year U.S. Treasury bond is guaranteed to lose money against inflation that was running at more than twice this rate in 2022. Nevertheless, many financial advisors and individual investors 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, especially when the Federal Reserve is adamant about raising short-term interest rates to 5%+.

We continue to emphasize several points that concern us about long-term 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 further 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 change of direction on maintaining a higher interest rate environment while high inflationary conditions remain. In due course, the Fed's action to raise interest rates precipitously puts pressure on the value of fixed-income instruments as well as other interest-sensitive assets.

In 2023, we have tranches of fixed-income instruments coming due and believe that the best opportunity for placing fixed-income funds is currently in short-term U. S. Treasuries earning approximately 4.5% to 5%. Consequently, we will seek 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 2022, Founders associates worked closely together, demonstrating the same level of care for others as they do for themselves. This "others-centered" vs. "self-centered" mindset permeates Founders, and we are 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 stay resilient and adapt to a changing environment. We continue to share a greater portion of our duties within the firm, allowing everyone to grow in their responsibilities. At the beginning of 2022, we had the privilege of Anna Case (Jon's daughter!) joining our firm. Anna brings vast experience to Founders, having worked in private equity at Macquarie and client management at Morgan Stanley after graduating from Colgate. Anna's focus is assisting clients with asset and estate management. We welcome Anna with open arms! Lisa continued to take on additional operational and regulatory compliance duties this past year and finalized the onboarding of our new compliance firm. We all thank her for seamlessly executing the new compliance procedures and associated software, and we are grateful for our smooth transition. Ted continues to administer our security filings with the SEC (which continues to get more complex) and to facilitate and manage trading, along with relationships with trading firms; and he has undertaken additional equity research responsibilities, including evaluating large Founders commitments (Ted does a great job managing a lot of spinning plates!). Jeff departed Founders late in the Fall to pursue other opportunities. We wish him the best of luck in his career pursuits.

Howard and I feel fortunate 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 2023.

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. *the largest equity position in each industry group to which Founders has allocated capital; and*
3. *all equity positions that account for 3% or more of the total funds allocated by Founders to equity 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.

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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
- **Heed 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
- **Continuously 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 its industry, 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.