January 14, 2019

Dear Clients and Friends,

We are pleased to present our year-end 2018 investment commentary. For our clients, please find enclosed your appraisal at December 31, 2018, your estimated realized gains and losses for the year, and your performance report.

Readers of this letter may recall our expectation one year ago that "near term returns [in stocks and bonds] would disappoint due to valuation and economic factors." In fact, the major stock market indexes recorded their first down year in a decade, with the S&P500, MSCI World and Russell 1000 Value indexes returning -4.4%, -8.7% and -9.0% including dividends, respectively. In volatile markets our investment strategy of owning wide moat, shareholder oriented companies trading below their intrinsic value is an anchor to windward, and that approach fared well for our clients as markets whipsawed last year.

Trade Wars and Tighter Money

For investors accustomed to a benign stock market, the fourth quarter was especially volatile as the S&P500 recorded its worst December since the Great Depression. Investors who disregarded quality in the search for yield, including some of the most widely followed hedge funds, suffered large declines in lesser quality securities. Bonds offered scant shelter as short term interest rates climbed, the yield curve flattened and credit spreads widened. Commodities fell too, with gold, silver, copper and crude oil all declining. Bitcoin collapsed. Cash outperformed nearly every asset class.

Investors are rattled by an escalating trade war with China that is starting to disrupt supply chains, and a more hawkish Federal Reserve, which raised rates four times in 2018. Fears that the US economy may tip into recession are evident in stock and bond markets, as credit spreads widened more than 200 basis points in the fourth quarter alone. Longer term concerns include the federal budget deficit, which is poised to rise sharply as unreformed spending programs and rising interest rates take an ever larger share of federal tax receipts. Among thoughtful global investors, concern that Russia may fail to manage its economic challenges peacefully competes with anxiety over China's emergence as an economic and strategic adversary. Partisanship and personnel turnover in the Executive branch have markets on edge. At 14.7x forward earnings the S&P500 ended the year trading below its average valuation for the past 15 years and close to bear market territory.

Daunting as these headwinds are, we view the decline in asset prices and valuations as a healthy step back that highlights the value of our investment approach. As context, America remains the envy of the world with 3.7% unemployment, core inflation barely above 2.0% and impressive real GDP growth. Other countries will record faster growth but none match the U.S. in its culture of innovation, legal and regulatory protections, and broad based economy. Even China, burdened by an ageing population, massive capital spending and an authoritarian political system, may prove a less agile adversary than many now believe. Oil prices, down 20% in the past year, are akin to a tax cut for consumers. Valuation is another positive: the earnings yield on stocks is 400 basis points higher than the yield on Treasuries, indicating a strong valuation advantage for equities. Further, the rise of passive investment strategies via ETFs and index funds has reduced price discovery and increased volatility, widening the opportunity for long term fundamental investors to uncover value.

Douglass Winthrop Advisors, LLC
521 Fifth Avenue, 19th Floor, New York, NY 10175
Telephone 212-557-7680 | Fax 212-401-4770
douglasswinthrop.com

Our portfolio includes a number of exceptionally well managed companies that we believe are undervalued, including long standing positions in Berkshire Hathaway, Brown-Forman and Markel, and others more recently added including CarMax, Discovery Communications and Mohawk Industries. Homebuilding and media companies are worth noting as certain stocks are available at prices well below intrinsic value. A closer look at Alphabet (formerly Google) illuminates the attributes we seek in prospective investments and helps explain why our confidence in our portfolio, balanced by geography, market cap and industry, is high.

Alphabet: a new Berkshire Hathaway

We first invested in Alphabet (GOOG) nine years ago, shortly after the company's IPO. The search business exhibited strong growth in revenue and free cash flow with low capital intensity and the potential to establish high barriers to entry. The company's culture, defined by its governance principles, long term focus and innovative method of selling shares to the public, were unique among the technology companies rising from the ashes of the dot com collapse a decade earlier. As GOOG has grown, the search business has become even better, driven by exceptional engineering talent and a network effect as more users attract more advertisers, which in turn helps the company optimize search algorithms and attract more users. With an estimated 80% share of the global search market and annual revenue growth of ~20%, GOOG has successfully managed the transition to mobile and become the dominant search provider worldwide. We believe this business alone is worth more than the current market cap.

Today GOOG accounts for virtually all Alphabet's revenue and more than 100% of its operating profit, however the reorganization of the company as Alphabet highlights management's strategy to invest beyond search. The purchases of Android, YouTube and Nest Labs – some criticized by analysts at the time of purchase – positioned the company to enter fast growing markets for content and artificial intelligence. YouTube, for example, with 1.9 billion registered users has more than 13x the number of Netflix subscribers and yet appears to be valued far less than Netflix currently. Equally intriguing have been so called "moonshot" investments in driverless cars and hosted cloud services. Cloud is a huge market dominated by Amazon, Microsoft and GOOG, growing rapidly as enterprises perceive value in enhanced security and scale economies from outsourcing. We believe these investments are valued at close to zero at the current price.

The durability of GOOG's business is reflected in the company's pristine financial position. With operating margins of roughly 25%, accelerating free cash flow growth and $100 billion in cash, GOOG does not depend on external capital to fund operations or growth. Conservative accounting policies understate the value of the core search business as well. At 20x our estimate of forward earnings (after adjusting for approximately $140/share in cash) GOOG trades at a p/e to growth ("PEG") ratio well less than 2x. In addition, GOOG reports GAAP earnings, unlike many technology companies that publish pro forma earnings adjusted for non-recurring charges and option grants. We believe GOOG's earnings are further burdened by GAAP requirements that a portion of the company's most promising long term investments be expensed, not capitalized as assets. Just as Berkshire must classify insurance float as a liability and carry wholly-owned businesses on its balance sheet at the lesser of cost or market, so too does GOOG adhere to GAAP policies that understate the earnings power of the company.

Parallels between Alphabet and Berkshire Hathaway suggest GOOG can be an excellent investment for years to come despite regulatory and competitive threats. Just as Berkshire built a world class P&C and reinsurance franchise, Alphabet has developed the world's dominant search engine, eclipsing rival offerings of Microsoft and Yahoo that were early pioneers in search. Berkshire generates cost-free float from insurance, which it uses to invest in non-insurance businesses from candy to railroads. Likewise, GOOG does not pay a dividend or repurchase meaningful amounts of stock, and instead reinvests free cash flow from search – now running at nearly $2.0 billion per month – in M&A opportunities and internal projects. The ability to allocate capital intelligently distinguishes these companies as much as their success as industry leaders.

New Year, New Office

As a new year begins, we are happy to report that our New York office has moved one block south to 521 Fifth Avenue, 19th floor. Please stop by if you are in the neighborhood or let us know when you'd like to schedule a portfolio review. Our partners and staff look ahead with confidence in our business and gratitude to our clients for the trust you place in our firm.

Sincerely,

Douglass Winthrop Advisors LLC