



Wedgewood Partners Third Quarter 2016 Client Letter

Is Indexation Investing the New Momentum Speculation?

“Too much of a good thing can be wonderful!”

Mae West

Review and Outlook

Our Composite (net-of-fees)ⁱ gained +3.07% during the third quarter of 2016. This gain compares unfavorably with the gain of +4.58% in our benchmark, the Russell 1000 Growth Index and the S&P 500 Index’s gain of +3.85%.

Top performance contributors included Apple, Qualcomm, Priceline, Visa and Charles Schwab. Absolute performance detractors during the quarter included Stericycle, Cognizant Technology, Core Laboratories, Mead Johnson and Express Scripts.

During the quarter, we trimmed our positions in LKQ and Mead Johnson, and we added to Core Labs, Visa, and Alphabet. We also initiated a new position in TreeHouse Foods.

Q3 Top Contributors	Avg. Wgt.	Contribution to Return
Apple Inc.	9.40%	1.63%
Qualcomm	4.31%	1.10%
Priceline Group Inc.	6.38%	1.05%
Visa Inc. Cl A	5.00%	0.54%
Charles Schwab Corp	2.48%	0.54%
Q3 Bottom Contributors		
Stericycle	4.46%	-1.17%
Cognizant Technology Solutions	5.42%	-0.90%
Core Laboratories	4.00%	-0.36%
Mead Johnson Nutrition	3.13%	-0.35%
Express Scripts Holding Co	4.34%	-0.30%

¹ Portfolio contribution calculated gross of fees. The holdings identified do not represent all of the securities purchased, sold, or recommended. Past performance does not guarantee future results. Additional calculation information is available upon request.

During the quarter, Apple was a top contributor to relative performance. Apple has been in portfolios for nearly a decade. Even though Apple is one of the most visible and widely followed businesses in our investment universe, we believe it has long suffered from the incorrect market perception that its customer relationships are largely transactional in nature. We see evidence of these "hit-driven" fears embedded in the systematic contraction of Apple's forward price-to-earnings (P/E) multiple. Apple's P/E multiple peaked in the fall of 2007 at about 38X (not long after the iPhone launched and the S&P 500 P/E peaked for that cycle) and has contracted to around 12.7X, albeit up from the 9X and 10x multiples seen earlier this year and in 2013. We earnestly admit that Apple probably does not deserve to trade at the 38X forward earnings², yet we believe that Apple's iOS franchise and "annuity-like" ecosystem has demonstrated an exceptional ability to retain and obtain repeat customers, while commanding over 90% of the profitability generated by smartphone manufacturers—qualities we think should help the stock generate extremely attractive returns at the current multiple.

Priceline was another top contributor to performance during the quarter. Despite its strong performance, in our view, Priceline's stock has underperformed its corporate fundamentals. Over the past three years, earnings per share are up a cumulative +60%, while the P/E multiple has contracted about 15%, to around 19X the next 12-month earnings. Further, if we assume that all stocks receive some kind of multiple expansion benefits due to currently low interest rates,³ then Priceline's multiple *contraction* looks all the more stark. Thus, although Priceline has executed torrid value creation relative to the benchmark, the stock has posted a fraction of the outperformance. We continue to think Priceline's competitive advantage consists of scale on both the supply and demand side of the hospitality industry. With over 90% of the Company's profitability coming from non-US markets, particularly from Europe, we believe their strategy of foregoing low-margin US bookings in favor of bookings in higher-margin, fragmented markets is a sensible one.

Qualcomm was also a top contributor to performance over the past three months. We saw Qualcomm make meaningful progress on its technology licensing (QTL) front after several quarters of patiently waiting for the Company to capture unpaid royalties in China. Although Qualcomm's chipset franchise (QCT) usually garners most of the attention for the Company, its high-margin QTL segment actually generates two-thirds to three-quarters of consolidated profitability. So while revenues at Qualcomm grew 4%, operating income grew almost 30%, year-over-year. Although it has taken several quarters to eventually materialize, we think that the "lumpy" nature of QTL revenues does not make Qualcomm's long-term prospects for monetizing its prolific research and development spend (cumulative \$16 billion over the past three years), any less attractive. In our opinion, Qualcomm shares remain underappreciated by the market, trading at just 14X next 12

² Though we sometimes wonder why its multiple never traded higher, given that the iPhone has been the most profitable product capitalism has produced in the past 50 years, yet many tech stocks have spent most of their incarnations as public companies regularly trading at 40x and higher – are their prospects *really that good*?

³ According to Factset, the Russell 1000 Growth Benchmark's cumulative earnings growth was about 20% while the P/E multiple expanded about 10% over the same trailing three-year period.

month earnings. In addition, the Company maintains a fortress-like balance sheet with about \$20 billion in net cash. As a valuation thought-experiment, if Qualcomm levered its balance sheet to be at parity with the average S&P 500 company's (excluding financials) net debt-to-operating earnings ratio⁴, the Company would have close to 35% of its market cap available for redeployment. We continue to expect that the long-term growth of the business will drive the stock higher and help close that gap, but our conviction in the stock is reinforced by the Company's excellent financial health, which is a byproduct of their superior profitability.

Stericycle underperformed during the quarter as headwinds related to their core, regulated medical waste (RMW) segment began to emerge. Prior headwinds to the Company were limited to non-core businesses or are short-term issues that should be remedied over the next few quarters. While the stock has become cheap, historically and relatively, we did not add to positions during the quarter, as we continue to evaluate the extent of the pressure the Company is seeing in its RMW business.

Core Labs was the third largest detractor from our relative performance during the third quarter. While "energy" continues to be a four-letter word at this point in the cycle of U.S. growth investing,⁵ we continue to think that Core Labs' value proposition is worthy of multi-cycle consideration. We estimate that roughly 85% of the Company's revenues are generated by providing equipment and services for the upkeep of their customers' *existing* carbon producing fields. As such, the majority of the value that Core Labs provides its customers is not directly predicated on the activity of drillings rigs, or even on the short-term price of oil. For instance, the Company's Reservoir Description business generated over 60% of consolidated revenues during the trailing 12 months. Reservoir Description revenues have declined just -16% from their trailing 12-month peak (set during late 2013 through mid 2014 – when oil traded at twice today's levels). A significant portion of Core Labs' revenues are generated outside the United States, so we estimate revenues in Reservoir Description have probably fallen by a high single digit percent, constant currency – despite the E&P industry (Core Labs' customers) drastically cutting budgets by between -30% and -75% during that timeframe. Thus, a significant portion of Core Labs' business is very well insulated from the vagaries of short-term oil price fluctuations. Although the margins of this segment have suffered more than revenues, we expect that margins have bottomed and should rapidly rebound with E&P spending budgets, as Core Labs' management has prudently balanced costs without sacrificing personnel capacity.

Cognizant also detracted from overall performance during the quarter, due to management's cautious commentary related to the demand environment in two of their core customer verticals. Management's caution about IT spend in Cognizant's BFS (Banking and Financial Services) segment trace back to the prolonged low interest rate

⁴ 1.8X net Debt to EBITDA http://www.factset.com/websitefiles/PDFs/cashinvestment/cashinvestment_9.26.16

⁵ According to Factset the Russell 1000 Growth Index Energy GICS weighting averaged 0.58% during the September 2016 third quarter; it reached as high as 10% in 2011.

environment along with increased uncertainty in the macro environment—particularly attributed to the “Brexit” vote, which was relatively fresh news at the time of management’s comments. We do not think this weakness has materialized in the near-term, at least to the extent that management was implying. In addition, but not necessarily new, Cognizant has four clients in the HMO (health-maintenance organization) industry, all attempting to merge with or acquire the other. Though the extended timeline of these M&A deals likely pushes out the timing of expected work for Cognizant at each of these four clients, we think Cognizant’s longer-term positioning as a key partner at all four HMOs will continue to allow them to capture wallet share, regardless of M&A outcomes. Near-term, we expect investors to remain skittish around the shares, if only because the investor base has been skittish for years, with the NTM P/E multiple of Cognizant typically vacillating 20%-30% per year. Despite these recent headwinds to topline growth, we think Cognizant maintains a long-term runway for generating attractive organic growth, as the company benefits from the secular shift of IT spend towards digital solutions. The Company maintains excellent financial strength, with nearly \$8 billion in borrowing capacity before reaching the average net debt to operating income leverage of the S&P 500—close to 25% of the current market cap.

Has the Outperformance of Indexation Run Its Course During This Cycle?

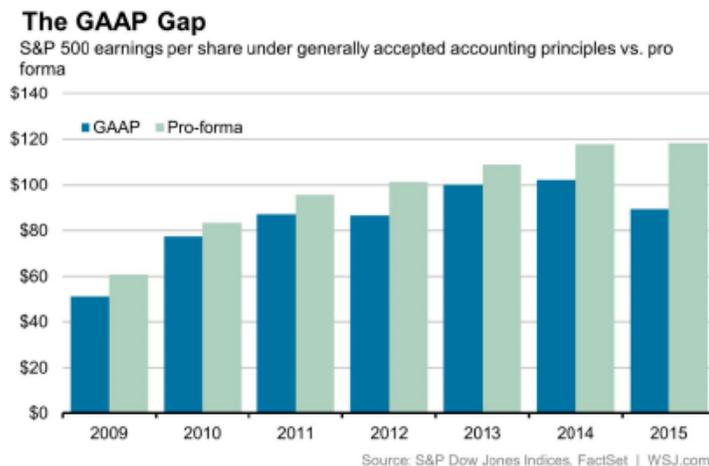
Our performance struggles versus our benchmark and the S&P 500 continued during the quarter. 2016 is on course to be one of the worst years for active managers over the course of the last two market cycles. Aside from this, we have noted (lamented?) in recent Client Letters, as well as in client meetings and client calls, our frustration (surely our clients’ frustration, too) that while our portfolio’s collective fundamentals (sales, earnings, cash flow, and book value) continue to grow in line—if not exceed—the same benchmark measures, our portfolio’s valuation has not kept pace with the valuation increase in our benchmark. The same applies to the S&P 500 Index as well. The net effect over the past few years is that our portfolio simply (and yes, frustratingly) gets cheaper still from the already discounted relative benchmark valuation.

The table below compares four fundamental growth metrics between our mutual fund, the RiverPark/Wedgewood Fund, our benchmark fund, the Vanguard Russell 1000 Growth Fund, plus the stock market, as represented by the Vanguard 500 Index Fund.

Growth Measures	RWGIX	VRGWX	VFINX
Historical Earnings %	6.61%	7.38%	6.23%
Sales Growth %	10.07%	8.37%	1.58%
Cash-Flow Growth %	11.64%	12.03%	1.37%
Book-Value Growth %	10.10%	2.95%	3.21%

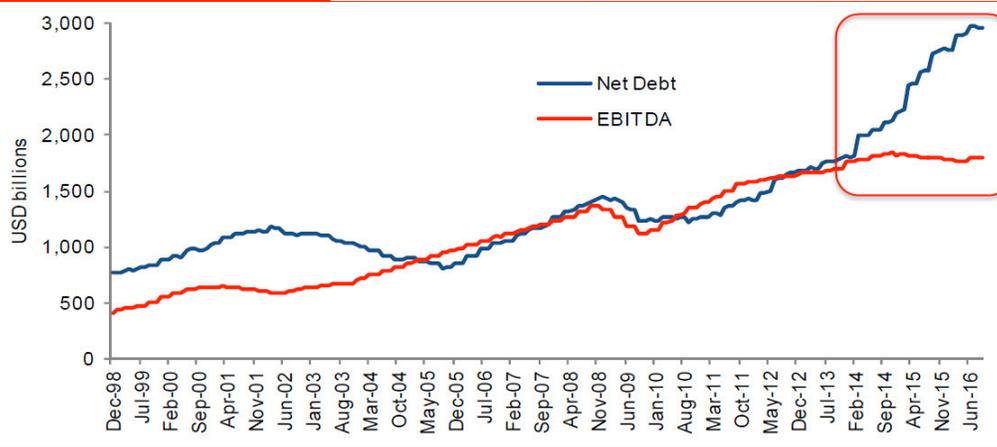
Source: Morningstar

The two notable observations, in our view, include the significant difference in both book-value growth and sales growth of our portfolio versus the two indices—particularly book-value growth. The important note on both sales and book-value measures is that they vary the least of the four between GAAP and non-GAAP. Notable too on this score is that the current accounting environment has seen the historical differences between GAAP and non-GAAP earnings are as great as ever. To illustrate these very real differences we have reproduced a graphic from our first quarter 2016 Client Letter.



The core element of our investment process revolves around superior profitability. The profitability that our companies generate represent value that our companies have created and captured. Our portfolio companies have three choices when they allocate this internally generated capital: Keep cash on the balance sheet (often in the form of deposits or long-term marketable securities); reinvest it in the business (in the form of capex, expenses or acquisitions); or pay it back to shareholders in the form of dividends and buybacks.

US corporate net debt and EBITDA (S&P1500 ex financials)

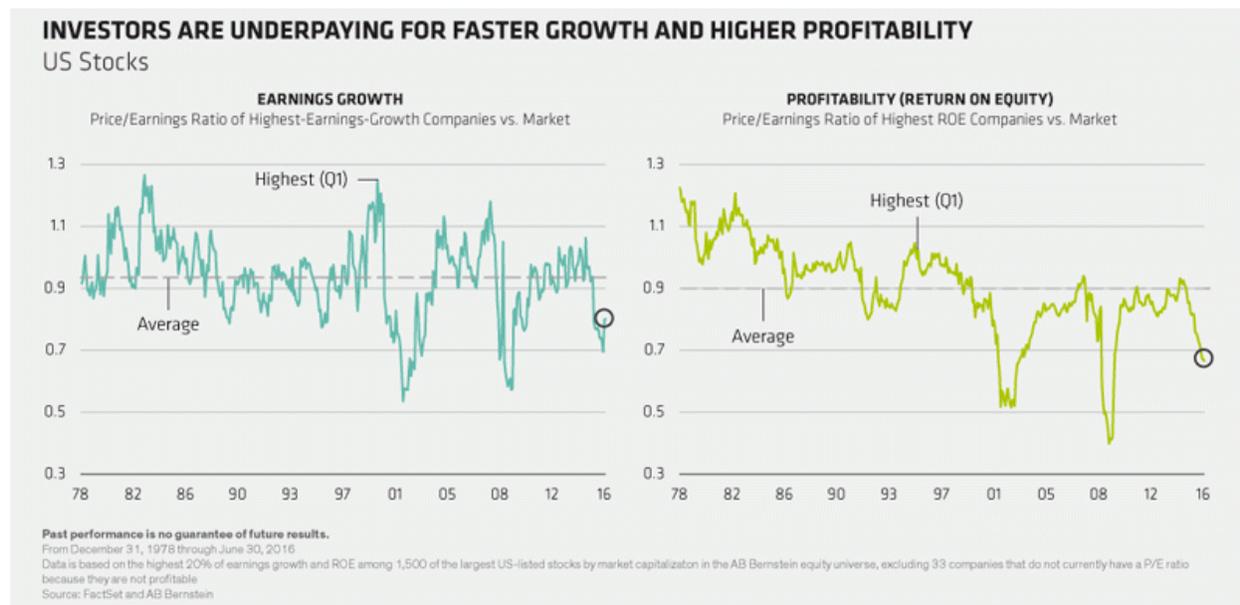


Source: Factset, SG Quant

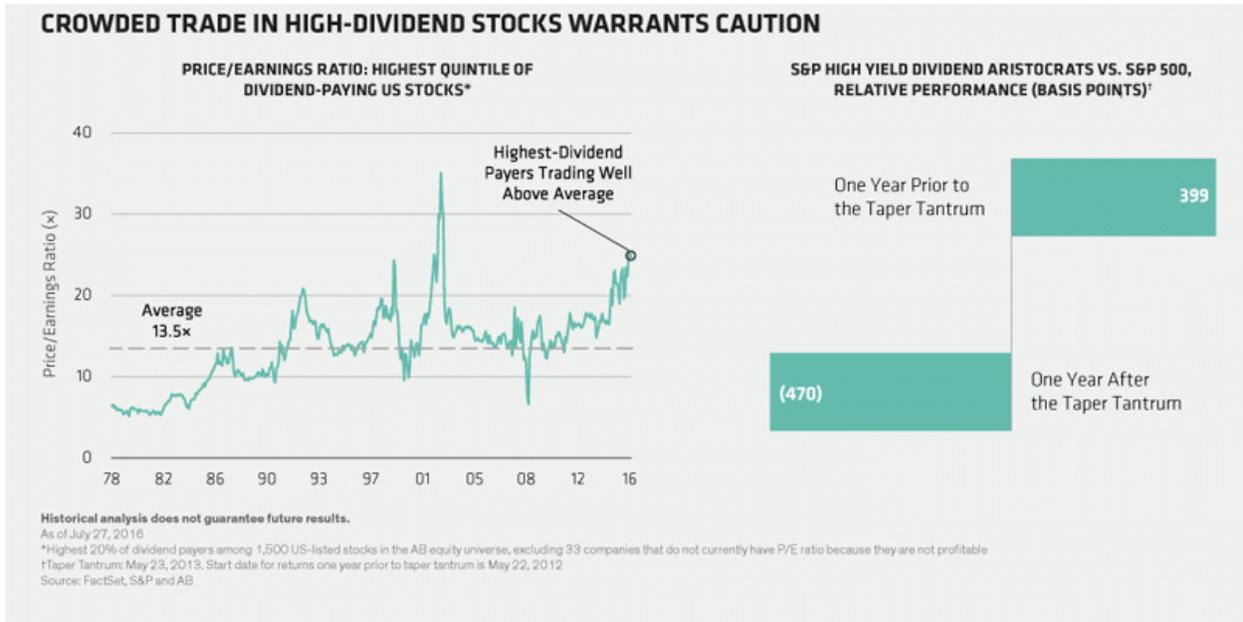
However, over the past few years of ultra-low interest rates, it seems that the first choice—keeping cash on the balance sheet—has actually become a value-destructive activity, both on an inflation adjusted and—more recently—a nominal basis. Nevertheless, our portfolio continues to have a very strong net cash to EBITDA ratio, with the majority of companies having more cash than debt. As such, the portfolio is “under-leveraged” compared with the broad S&P 500 Index, which typically carries a net debt to EBITDA ratio of about 1.8X.

As a thought experiment, we assumed that our “under-leveraged” portfolio companies simply “leveraged-up” to the average net debt to EBITDA of the S&P 500. We found that these cash-rich companies in the portfolio could generate capital equal to between 15% and 20% of their respective market capitalizations. We do not that recommend our companies do this. However, at the very least we believe our thought experiment helps illustrate how strong balance sheets have actually led to weak relative performance. We do not know when or what drives the market to change tact, but until then, we continue to ignore the market’s plea to treat cash as a liability.

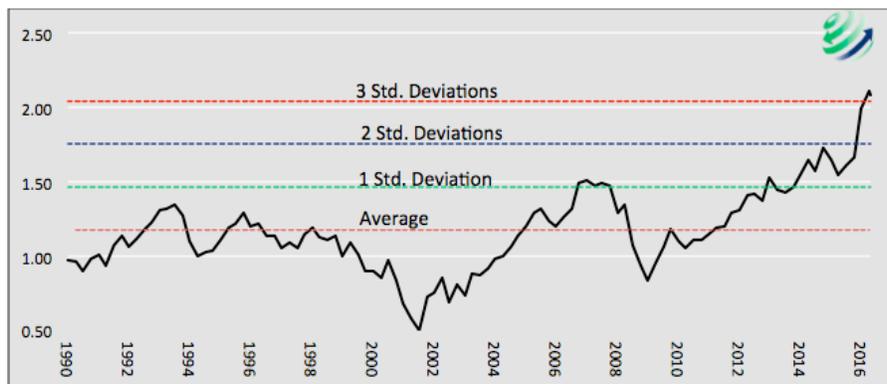
We can guess that monetary policy has had a significant hand in this development, but regardless of what is causing negative interest rates, we disagree with its embedded logic, namely, that a dollar of our companies’ profits today is worth less than a dollar of profits tomorrow. We would humbly argue that the Federal Reserve has increasingly become hostage to the current bull market. That said, if the tenets of prudent stock market investing are timeless and immutable, then bottom-up fundamental analysis plus valuation-sensitive price discovery will one day again trump Federal Reserve policy.



We discussed the chase for yield—and the related chase for “low-volatility” stocks in our last Client Letter (see [here](#)). Please consider too the graphics below on the historically stretched valuation of utility stocks earlier this year. (As a related aside, Vanguard closed its \$30 billion Dividend Growth Fund to new investors back in July.)

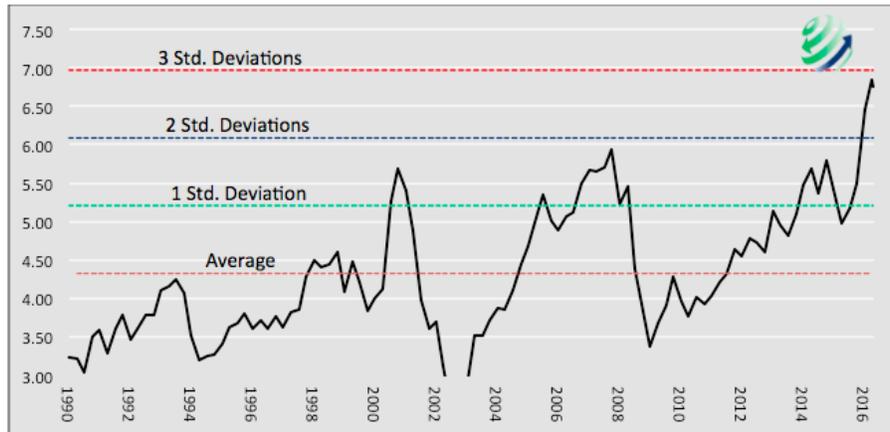


Price to Sales Ratio



Data Courtesy: Bloomberg

Price to EBITDA Ratio

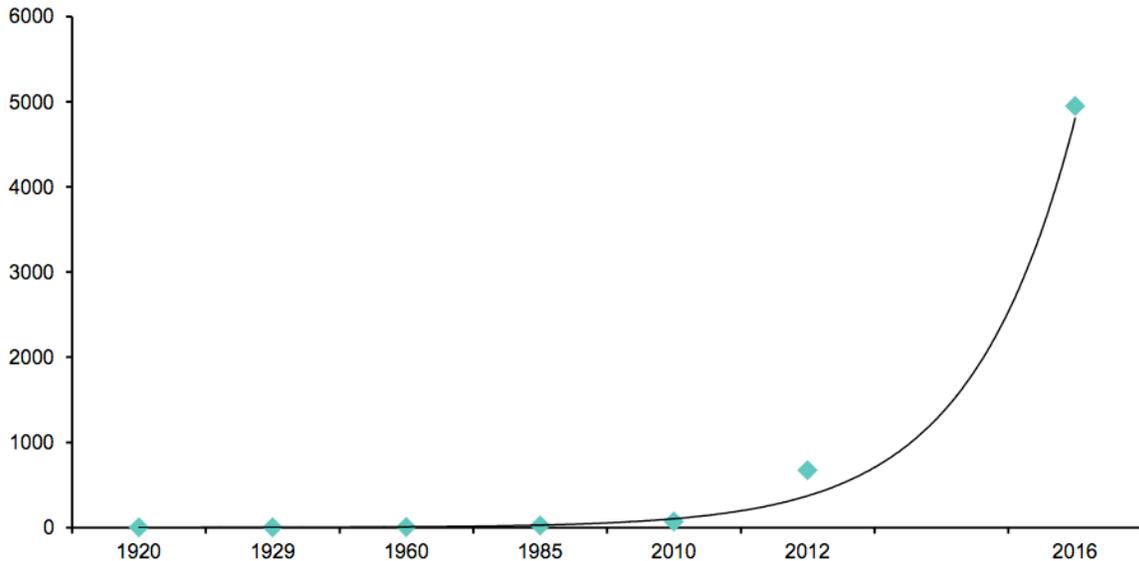


Data Courtesy: Bloomberg

Source: Michael Lebowitz and Bloomberg

In this Letter we would like to take a closer look at the impact from the near tsunami of billions flowing out of active investment strategies—and then flooding into passive strategies. Mae West’s philosophy that there should be no limit on enjoying wonderful things applies to much of life, but perhaps not so much in the world of investing. There is no doubt that the financial firms that provide passive and indexation financial products have seen boom times like no other.

EXHIBIT 1: The proliferation of indices



The first 5 datapoints are based on Wurgler (2011) "On the Economics Consequences of Index-Linked Investing"
 The last two datapoints refers to the cumulative number of factor indices (4274 from ERI Scientific Beta (<http://www.scientificbeta.com/#/concept/home-analytics-intro>) and 673 ETF's identified by Morningstar (<http://www.ft.com/cms/s/0/a5309ec0-43dd-11e4-8abd-00144feabdc0.html#axzz4Ek414pmW>))
 We have fitted an exponential curve though we have left the scale on the x axis non linear on purpose as in fact the recent rate of index creation exceeds that fitted by an exponential curve. Source: Wurgler(2011), FT, ERI Scientific Beta

The size of the net asset flows out of active strategies and into passive strategies during this bull market is simply staggering. According to DiMartino Booth, since 2008, over *\$1 trillion* has been invested in some type of index fund or ETF, whereas active managers have seen \$600 billion flee their firms. Further, according to Morningstar, from just the beginning of 2014 through this past August, approximately \$218 billion in assets have exited active strategies, while passive strategies have attracted even more, at \$336 billion—for a swing of \$554 billion!

According to *The Economist* magazine, which cited research from the University of Amsterdam, the holdings of the “Big Three” index asset managers, Black Rock, Vanguard and State Street, “treated as a single entity, they would now be the largest shareholder in just over 40 percent of listed American firms, which, adjusting for market capitalization, account for nearly 80 percent of the market.” Ponder that not so insignificant tidbit...

Consider the recent performance impact of this indexation feeding frenzy of such out-sized flows into funds and ETFs that passively invest in our style benchmark, the Russell 1000 Growth Index—specifically the Vanguard Russell 1000 Growth Index. Through the end of the third quarter, this fund’s 1 and 3-year percent ranking in Morningstar’s Large Growth category is a most impressive top 14% and 12%, respectively.

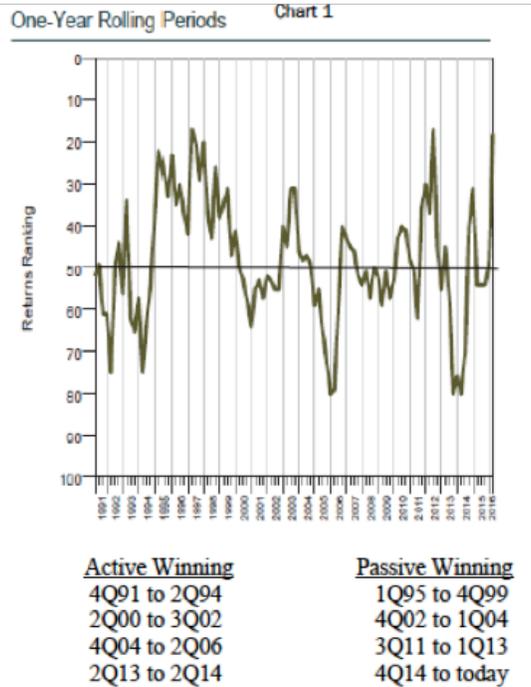
Consider too the outsized performance of just two stocks—Amazon and Facebook—in the benchmark. The gains in just these two stocks over the past few years have been sterling. Through the third quarter, over the past three years, one year and year-to-date, Amazon has gained +164%, +55% and +31%, respectively. Facebook clocks in with equally impressive gains of +160%, +37% and +26%. Active managers who have not owned these two stocks (us included), or were underweight these stocks relative to the benchmark, have faced a relentless performance headwind.

Lastly, consider too both the performance impact on the benchmark’s current portfolio weightings and valuation. As of the third quarter, the top five stocks in the increasingly top-heavy benchmark (Apple, Alphabet, Microsoft, Amazon, and Facebook) represented nearly 20% of the benchmark indices. The top 10 stocks represent a 27% weighting. (Related top-5 and top-10 weightings in the Vanguard Russell 1000 Value Index are approximately 21% and 13%, respectively.) Amazon and Facebook have driven the benchmark’s valuation to extremes as well. The weighted average trailing P/E of the benchmark’s top five stocks is 57X – the top-10, 49X.

Such metrics beg the question: when does a “diversified passive” index become an “undiversified active” strategy? Given the poor track record of active managers over the past few years, the seemingly obvious call is to fire one’s active manager and join the parade into passive investing. Unfortunately, the obvious investment decisions, in our view, are usually poorly made and poorly timed. In fact, at the current junction of this +7½-year bull market, prudence—along with future prospective outperformance—may well call for firing one’s passive manager and hiring more active managers. Lastly, and perhaps not so coincidentally, passive strategies’ significant performance dominance over

active strategies since late 2014 has also been the same period of our worst relative performance in our strategy's +24-year history.

Do “Active” versus “Passive” Relative Returns Mean Revert? We Think So.



Source: Leuthold & Co.

So what could it be in the current investing environment whereby portfolios that historically exhibit both better growth and profitability have failed miserably to keep pace with the benchmarks, which have posted poorer fundamentals? Our answer is two-fold. First, the near -50% collapse in interest rates over the past three years, and the concomitant chase for yield by investors in both the bond market and the stock market, which has pushed higher dividend yielding stocks (and low-volatility stocks) to historically out-sized valuations. And second, is that the typical late-cycle bull market flood out of active investing strategies and into valuation agnostic passive strategies has been a self-fulfilling prophecy, as it were, propelling indices to ever higher valuations and outperformance, which in turn attracts even more performance-chasing asset flows.

Related to the collapse in interest rates is that “cash” in one’s investment portfolio has been, well, trash over the past few years. The reward for holding any cash has been penalized with zero return. Mr. Market too, in our view, has penalized companies that possess cash-rich balance sheets. The rewards for shareholders getting the cash off of corporate balances (and leveraging up with debt too) by boosting dividends and share buybacks, plus mergers and acquisitions have been rewarded quite nicely in the current

“risk-on” environment. We prefer to invest in companies that play by a different, more conservative all-weather approach to the capital allocation of retained earnings.

Company Commentaries

TreeHouse Foods

We initiated positions in TreeHouse Foods, Inc. during the third quarter. TreeHouse is the largest private label food manufacturer and distributor in North America. An aphorism in the private label industry is that “a grocer is only as good as their private label.” As such, private label food has been growing its share of the North American food industry over the past several years, as consumers have sought value in comparison with branded food, and as grocery retailers and other food vendors have pursued the greater profitability to themselves of private label products. This trend primarily began in national-brand equivalents, in which TreeHouse and other private label manufacturers offer products of comparable quality to brand names but at better prices. However, much of TreeHouse’s growth in recent years has come from premium products, which often might be natural/organic/healthy choices and possibly of even greater quality or featuring greater innovation (flavors/recipes) than competing branded products. Having evolved from simply offering retail customers a “good/better/best” option of national brand equivalents, the Company has begun to offer deeper category segmentation and insights, while developing and manufacturing multi-tiered pricing assortments, so their retail customers can better compete under the pricing umbrella typically created by higher priced national brands. Many of TreeHouse’s best customers, including large, growing retailers such as Trader Joe’s, Aldi’s, Amazon, and Kroger, have embraced this more complete portfolio strategy of private label products, which offers the retailers not only improved profitability but also better sales opportunities, as well. In addition, TreeHouse’s scale and presence in over 20 food categories, enhances its value proposition, which is to help grocery customers hone in on this secular trend towards customized store brands.

The Company has been growing successfully through acquisition since its formation in 2005. TreeHouse has driven value in its acquired businesses by bringing to bear greater operational capabilities and expertise, greater resources behind innovation and customer research, much greater scale and buying power, and an extensive existing customer list into which the acquired businesses could sell. In early 2016, TreeHouse completed the transformational acquisition of the Private Brands business of ConAgra Foods, effectively doubling TreeHouse’s revenue base and operating footprint while removing its only private label competitor of any meaningful size, all at what we view as an attractive purchase price. The acquired business had struggled under the ownership of ConAgra, which historically had been a branded player and which had not understood the different skill set required to operate a private label business. We believe that TreeHouse comprehensively understands these operational issues and already has begun to remedy them. Better execution at the acquired business, which will drive improving revenue growth and margins, combined with significant cost savings opportunities as a result of the

combined companies' greatly enhanced scale, will allow TreeHouse to deliver roughly 70% earnings growth from the time of the acquisition to the completion of its integration in 2018. During this integration, we likely will see smaller tuck-in acquisitions, as the company's capital structure still allows it to be active in consolidating the industry. We estimate that the company has less than 10% market share in North America, with plenty of room to expand organically and through acquisition, both within its current 20+ product categories and in adjacent and new categories.

We think TreeHouse's dominant scale and attractive growth opportunity are unique enough to warrant an initial position in portfolios. As the company executes its strategy, we expect strong operating earnings growth to drive the performance of the stock, which we think currently trades at an attractive price to growth multiple.

We hope these Letters provide some added insight into our portfolio strategy and process. On behalf of Wedgewood Partners, we thank you for your confidence and continued interest. As always, please do not hesitate to contact us if you have any questions or comments about anything we have written in our Letters.

October, 2016

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ⁱ Returns are presented net of fees and include the reinvestment of all income. “Net (Actual)” returns are calculated using actual management fees and are reduced by all fees and transaction costs incurred.