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*It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price.*
*–Warren Buffett*

Lorne Steinberg,
MBA CFA
PRESIDENT

# Paying Up for Quality

Dear Client,

Ever since the start of the war in Ukraine in February 2022, there has been what seems to be an avalanche of bad news and worrisome headlines for investors to deal with, both economic and geopolitical.

The war in Ukraine is now in its third year, while the situation in the Middle East remains volatile with concerns of regional escalation. Added to all of this are the recent weather disruptions and the upcoming U.S. election. On the economic front, central banks have finally tamed inflation, but at the cost of a slowing economy due to higher interest rates.

However, despite all these various issues, corporate profits have remained strong, economies have been surprisingly resilient, and patient investors have been rewarded.

The conclusion is that while negative news can cause day-to-day market volatility, it has no impact on long-term stock market performance.

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# Pillars of Great Businesses

When one takes a look at many of the world's great businesses, they may be in very different industries - from technology and banking to consumer products and communications. However, great companies share certain attributes:

1. **Brand Strength:** The best companies in the world have built sustainable brands or "moats" around their business that would be very difficult (and expensive) to replicate. Consider Kraft Heinz. They own some of the best-known consumer food brands including Heinz Ketchup, Mac & Cheese, and Philadelphia cream cheese. These brands have remained #1 in their respective categories for decades because Kraft Heinz has continued to invest heavily in their brands.

It would be extremely difficult for another company to duplicate the success of these brands, as building a successful brand often takes decades and significant financial investment. A company such as this is said to have built a deep moat around its business. We love businesses with strong protective moats.

2. **Financial strength:** Great businesses have the financial wherewithal to stay ahead of competitors, hire the best talent, and effectively navigate difficult times. Think of Starbucks. We recently purchased shares in this company after the price had declined significantly. There were several reasons for the weakness: the CEO, who had come from a different industry, had made a number of missteps; sales in China (a major market) had slowed; and the drink preparation in the stores was taking too long.

Despite all of these issues, Starbucks continued to generate over $3 billion of free cash flow, while remaining the dominant player in the industry. After firing its CEO, the company was recently able to attract one of the leading CEOs in the fast-food industry due to its market position and financial strength.

3. **Track record of intelligent capital allocation:** Great companies don't just generate excess cash, they also invest that cash in such a way as to increase shareholder value. Companies can allocate capital by making acquisitions, buying back shares, paying dividends, or reducing debt.

Allstate is a great example of a company that has done an outstanding job of allocating capital via share buybacks. Over the past twenty years, the company has reduced its share count from 709 million shares to 264 million today (an average of about 22 million shares per year). At that rate of buying back shares, by 2036 we may find ourselves owning the entire company!



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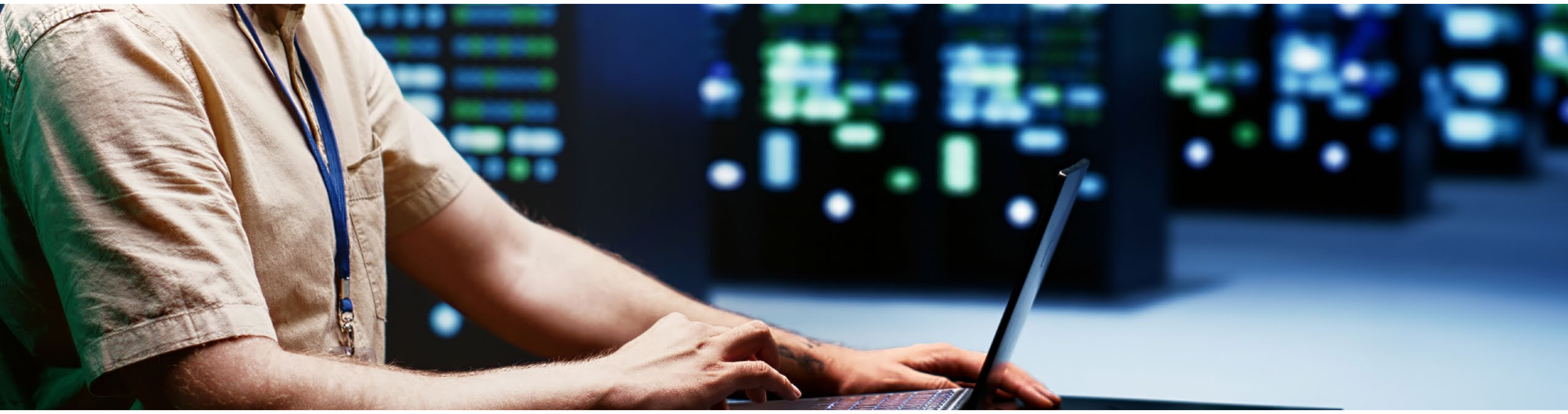

# The Value of Quality

In 2011, we bought our first shares of Microsoft. The stock was trading for $25 per share, and the valuation was cheap because growth had stalled due to management mistakes. That said, the company was still the world leader in computer desktop technology with Windows and Office, and was generating plenty of free cash flow. The problem was that Steve Ballmer, the CEO at the time, was not allocating that cash well. Our analysis was that, given the strength of the balance sheet, and free cash flow generation, the shares were worth considerably more, and if the company allocated its cash more wisely, the valuation would be materially higher.

Over a short period of time, things started to improve at Microsoft, and in 2014 the company replaced Ballmer with Satya Nadella, who remains the CEO today. Under Nadella, the company began to roll out its cloud business, while Office was moving toward a subscription model known as Office365.

In 2017, when the share price reached $75, our investment committee reassessed the fair market value of Microsoft at closer to $150 per share. When this target was reached, our valuation was then closer to $280 and today, at a price of $400, we still see attractive long-term value.

Microsoft is not as cheap as it once was, however, it is one of the highest-quality businesses in the world and, as investors, we will gladly pay up for quality, as long as the balance sheet remains pristine, free cash flow generation is strong and growing, and the company is trading for less that we believe it to be worth.

In contrast to Microsoft, we recently sold our shares of Ferrari.

At the time of purchase, Ferrari was not a traditional "value" stock (P/E of 30), however, given the strength of the balance sheet, the competitive moat around the business, and the iconic brand quality, our estimate of fair value was significantly higher than the share price at that time.

In the three years since our initial purchase, everything had gone well for the business, and management was doing an excellent job. This would suggest that we would comfortably hold these shares for many more years. However, the valuation rose to such a high level, that the shares were "priced for perfection" and our margin of safety had evaporated.

As investors, we must have the discipline to sell positions that are trading for more than we believe them to be worth, and we did just that with Ferrari. Should the company stumble (or perhaps blow a tire!) and its share price fall, we would more than likely be very happy to initiate a position once again.



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## Recent Purchases

**Automatic Data Processing (ADP)**

While working as an accountant after the Second World War, Henry Taub became increasingly aware of the difficulties that small companies faced in handling payroll efficiently, a manual process that was both time-consuming and prone to much error. He saw an opportunity to create a specialized service that could take on this administrative burden for businesses and thus founded Automatic Data Processing (ADP) in 1949 in Paterson, New Jersey.

Initially, the business operated as a manual payroll processing company but, during the 1950s, began automating its services by adopting the cutting-edge technology of the day, namely punch card machines. Today, ADP is a leading provider of payroll processing, HR management, and other business outsourcing services, managing over one million clients globally. Some 90% of their revenue is derived from North America, and they process paychecks for 1 in 6 American workers. Given that their clients rely on ADP to handle essential functions such as paying employees and managing benefits, they boast a very high 90%+ customer retention rate and have been able to grow revenues even through economic slowdowns (including during the Global Financial Crisis!). With ever-evolving regulatory demands, changes to taxation, etc. providers such as ADP become increasingly indispensable to their clients. The company invests heavily in new technology, spending approximately four times more on payroll innovation than its competitors. They maintain a very strong balance sheet (rather vital when you typically hold $40 billion of customers' funds at any one time) and have delivered 48 consecutive years of dividend increases.

## High Yield Bonds

A review of the high yield bond market and our high yield fund is available here: High Yield Quarterly.

## Final Thoughts

As we write this letter, markets are near all-time highs and the largest technology stocks have been the primary contributors to the market gains. While we own a number of stocks in the tech sector, we continue to see exceptional value in businesses that share the attributes of the kinds of companies we highlighted above in "Pillars of Great Businesses," such as ADP.

Warren Buffett's quote at the top of this letter reflects our shared belief: investors will generate better returns over time, while taking less risk, by investing in high-quality businesses at reasonable prices, rather than opting for lower-quality businesses simply because their shares appear inexpensive.

Sincerely,

Lorne Steinberg

Lorne Steinberg
President





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