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Q3 2017 Quarterly Commentary – October 1, 2017: Prospects for Tax Legislation Reinforce Market Advances

With September's higher close, we have experienced eleven consecutive months of rising stock markets (an all-time record), fueled by optimism over the prospects for economic expansion, corporate earnings growth and tax reform. During the most recent quarter ended September 30, 2017, the S&P 500 returned 4.5% including dividends, while the Dow Jones Industrials and NASDAQ Composite Index produced total returns of 5.6% and 6.1%, respectively. Meanwhile inflation readings remain tame at roughly 2%, keeping a lid on interest rates. The 10 year Treasury yielded 2.3% at quarter-end, very little changed from a reading of 2.4% as of the start of the year. Bond returns for the third quarter of 2017, as measured by the Barclay's Aggregate Bond Index, were 0.85%. Persistently low interest rates and an expectation that they will remain that way provide investors the confidence to pay a higher multiple of earnings and cash flows when valuing businesses. Higher valuations are therefore not an aberration, but are to be expected under these circumstances.

Corporate Tax Proposals

Coming off the failure to repeal and replace Obamacare, Republicans in Congress are under intense pressure to pass something (anything, really) in the current congressional term to provide a case for their own reelection, so the odds are good that some form of tax legislation will be enacted by early 2018. Warren Buffett quipped in an interview this week, "any politician that can't pass a tax cut probably is in the wrong line of business." The market's recent strength is in part a reflection of Wall Street's optimism that tax relief in some form will pass, and that a new tax regime will be friendly to American business.

The primary areas of interest by legislators that effect corporations include (1) a reduction in corporate tax rates to align with international norms, offset by limitations on interest and other traditional corporate deductions; (2) a move to a territorial corporate tax system whereby US corporations will no longer have to pay US taxes on foreign earnings; (3) a framework to allow US corporations to repatriate past and future foreign earnings; and (4) incentives, likely temporary, such as accelerated depreciation on capital equipment for new business investment.

There is also a long list of proposals relating to individual taxation, some of which might meaningfully affect your returns in 2018 and beyond, but it would be hard for one to argue that the items noted above, if passed in whole or part, are anything but positive for corporations.

We think it's fair to say that the buildup to the most recent proposals has been positive for the stock market, but there have been other factors as well. The weakening of the US dollar against foreign currencies in 2017 and the stabilization of energy prices have played a role in bolstering corporate profits. The economy has recovered somewhat from its malaise in recent years, with real GDP registering growth of 3.1% in the second quarter.

Today we stand at market valuations that are high overall on an historical basis, with the S&P 500 trading at 21.8x trailing earnings and 18.1x one-year-forward estimated earnings. As we noted above, higher valuations are not irrational under the current economic conditions, but they nevertheless give us some pause, and have us looking at the investment landscape with a degree of conservatism. We think the benefits to corporate America of the tax proposals discussed above are largely "priced in" when looking at current valuations. This does not mean we cannot or will not put money to work when we see an opportunity. Later in this letter we will speak to some of the transactions we executed on your behalf during the quarter. As always, we will take a critical look at business fundamentals before committing your wealth to an idea, and remain disciplined on the prices we will pay for any stock. This is our job.

Individual Tax Reform

We will likely see some changes, but it will be a long and arduous road from the "framework" presented by the Administration to any revision to the tax code, as every line item in the code has a lobby that will fight fervidly to protect it. Further, the Byzantine legislative process chosen by Republicans to draft the legislation (the same ones used in the Obamacare repeal effort, designed to avoid Senate filibuster) is reflective of our divided and dysfunctional government.

First, since Democrats will have little interest in advancing policy drafted by the opposition, the new tax regulations will need to be written under procedures requiring a simple majority rather than the traditional 60 Senate votes required to advance legislation. Specifically, Republicans will first have to pass a budget resolution and then draft tax policy using the legislative process called reconciliation. Second, because this legislation will be written in reconciliation, it will have to be "revenue neutral" (or nearly so), meaning that the rewritten code must be shown to not add to the deficit over the coming years, else the new rules will be made temporary. Third, as became clear in its failed attempt to repeal and replace Obamacare, the Republican Party does not speak with one voice. The margin in the Senate is narrow to begin with, so it takes only a few dissenting members on the Republican side to scuttle any attempt at tax reform. The net result of this complexity is that the ultimate legislation may look a lot less like tax reform than like a few tweaks to the code on the margin.

We will see, but it's probably too early to speculate on the ultimate package. We note that the Federal government's budget calls for about $4.1 trillion of spending. The money to fund this budget has to come from somewhere. If we are to hold our government's budget deficit to a manageable level, which will be essential to winning Republican support for this legislation, a reduction in our tax rates must be accompanied by a limitation on deductions or some similar item in the code for the math to work. Since the primary offsets to taxable income on most tax returns in California are the mortgage deduction, property taxes and state income tax, all of which are either on the chopping block or at risk of being capped, we may not benefit at all from the tax package. But it's too early to know, and we have no plans yet to move to Nevada.

Please don't hesitate to give us a call as the details are revealed. With all of the uncertainty surrounding tax reform, we can't be certain we'll know the right answer to all of your questions, but we will do our best to stay apprised of the issues. Our role is to help you do the research, and if appropriate, to connect you with the best professionals in our stable of relationships to get you the answer you need.

<u>Q3 Portfolio Changes</u>

Please keep in mind, these commentaries should not be construed as a recommendation to buy or sell the securities discussed. Such decisions are made only within the context of the market environment as we perceive it at the time of the decisions and the structure of the diversified portfolio of which the securities are a component[***].

<u>Chipotle Mexican Grill, Inc. (CMG)</u>

Chipotle is the leading fast-casual restaurant in the U.S., offering Mexican-style food made from whole ingredients using traditional cooking techniques for under $10. We initiated a 3% position in Chipotle during the quarter after a norovirus outbreak at one of the company's Virginia locations led to a significant decline in Chipotle's stock price, thereby creating what we believe will prove to be a favorable buying opportunity. Importantly, the norovirus outbreak was unrelated to the company's 2015 food safety issues that many of you have heard about, the latter of which has been resolved by management through a series of operational improvements.

Despite the recent negative headlines, we believe Chipotle's business is poised for a return to growth. New menu items and marketing campaigns planned for later this year should attract more diners, while technology initiatives in support of online and mobile ordering will allow each restaurant to serve more customers. In addition the company recently raised prices by 5% in many markets without witnessing any decline in unit sales volumes. The successful price increase comes as no surprise to us given that the company's service speeds and product quality are vastly superior to its competitors.

We believe Chipotle's business has a long runway of growth ahead of it, as management believes the restaurant concept can support 5,000 restaurants in the U.S. alone vs. 2,300 today, with potential to expand into new markets overseas. Our confidence in the company's growth trajectory of both restaurant units and earnings per share is further reinforced by that fact that activist investor Pershing Square recently won board representation and has the potential to create value for shareholders by urging the company to repurchase shares at attractive prices.

CMG shares trade at a reasonable valuation on normalized earnings based on the current recovery trajectory, and very cheaply relative to the company's historical earnings power.

Laboratory Corporation of America Holdings (LH)

In addition to Chipotle, we initiated a 2% position in LabCorp during the quarter. LapCorp is the nation's second-largest independent clinical laboratory, occupying roughly 20% of the independent lab market. The company operates more than 1,800 patient-service centers, offering a broad range of clinical lab tests, ranging from routine blood and urine screens to complex oncology and genomic testing. With the recent acquisition of Covance, LabCorp also has a sizable footprint in the global contract research organization ("CRO") market.

LabCorp's competitive advantage stems from its massive scale in the diagnostic lab business making the company, along with key competitor Quest Diagnostics, the low cost provider in the market, able to earn higher profits at lower reimbursement rates than smaller industry incumbents. LabCorp enjoys a long growth runway ahead of it, as the company takes market share from higher cost community and hospital labs. In addition, LabCorp's growth runway will benefit from long-term secular trends favoring increased diagnostic testing due to an aging population, new innovative treatments, and a shifting reimbursement landscape that favors measurable outcomes.

The company's Covance CRO business has a large organic growth opportunity given favorable trends in R&D outsourcing, and large global CROs like Covance are best positioned to increase market share. In addition, the CRO business has favorable synergies with the diagnostic lab business. By incorporating clinical lab data into the CRO business, LabCorp has created a compelling product that helps biopharma clients complete clinical trials faster.

Our research suggests that threats from disruptive technology (e.g. Theranos) and from large hospital chain insourcing have abated, supporting continued low single-digit organic revenue growth in the core lab business.

Observations of management suggest they're thoughtful about capital allocation, and the stock's valuation looks reasonably attractive even using conservative estimates of value.

Wells Fargo & Company (WFC)

On August 11th, we decided to exit our 2% position in Wells Fargo. The primary reason to remove the name from the portfolio was because our valuation models indicated that both Bank of America and Citigroup trade in the market more cheaply. Therefore, we utilized the proceeds from the sale of Wells Fargo to increase our positions in both Bank of America and Citigroup by 1% each.

Stericycle, Inc. (SRCL)

We initiated our position in Stericycle back in July 2016 after the stock had declined by 40% from its previous high. Despite our concerns that management had made some poor capital allocation decisions and that the business needed improvements to its internal controls, we believed an investment was warranted given Stericycle's strong competitive advantages derived from sizable barriers to entry, high customer switching costs, and advantages of scale. In addition, our research indicated that the company's three main segments (i.e. medical waste, hazardous waste, and document shredding) would be highly desired acquisition candidates and that missteps by management could very well attract the attention of activist investors, as has so frequently been the case in recent years for companies facing similar issues.

Over the course of our holding period we continued to monitor Stericycle, as is done with all holdings, and became aware of other issues facing the company. Specifically, we learned that a fairly sizable percentage of customers had been overcharged in previous years for medical waste services, unbeknownst to these customers. Additionally, we learned that the company was facing some not immaterial legal issues in its hazardous waste business.

Given the issues mentioned above, we decided to revisit our investment thesis and, despite Stericycle's extremely powerful portfolio of businesses (especially in medical waste), we decided that an investment in the firm was no longer warranted. Accordingly, we exited the position during the quarter.

Time Warner, Inc. (TWX)

In October of 2016 Time Warner received a buyout offer from AT&T for $107.50 per Time Warner share. Over the course of the next ten months we maintained our position in Time Warner given the company's undervaluation, the large spread between the company's stock price and AT&T's buyout price, and our belief that anti-trust approval was highly certain. As the spread between the stock price and buyout price narrowed, and as management revealed more information about how the combined entity would operate, we concluded through our research that the complexity of the combined entity's operations rendered an assessment of its future economics futile. Accordingly, we sold the position.

Announcements

One new professional joined the firm during the third quarter, and another has agreed to start with us in October, bringing our headcount to 31. We are delighted to have Charles ("Charlie") Angle on the team, serving as a Financial Planning Associate. Charlie comes to Golub Group from the San Francisco office of Banque Nationale de Paris, where he served as a Private Client Advisor. A San Francisco native, Charlie was educated at the Lycée Français (and is consequently fluent in French) and attended the University of St. Andrews in Scotland. Please say "bonjour" to Charlie when you pay us a visit. We are equally pleased that Aleese Peterson-Cotton has joined the firm as a Financial Advisor. Aleese was most recently a Vice President and Private Client Advisor with US Trust in San Diego, providing solutions to an ultra-high-net-worth clientele, following a number of client-facing advisory and service roles at Bank of America. Her move north to San Francisco was a homecoming of sorts, having grown up on the northern coast of California and been educated at Humboldt State University.

We look forward to speaking with you, and if you would like to come in for a visit, please drop us a note or give us a call. Meanwhile, if you have friends or loved ones who might benefit from reading this commentary or starting a dialogue with us about their financial circumstances, please don't hesitate to forward it to them.

Golub Group