April 7, 2021

Dear Clients and Friends,

In March the world observed the first anniversary of the lockdowns prompted by the COVID-19 pandemic. The past year will long be remembered for the profound loss suffered by many and the disruption of important life plans experienced by all. A bleak winter brought a third COVID surge, political turmoil and significant weather disruptions. In the face of such gloom, the first green shoots of spring, marked by warmer weather and nascent economic revival, have rarely been more welcome. Overcoming unimagined challenges, America's ingenuity and adaptability have been on full display as vaccines have been developed in record time, and technology has kept many companies (including Douglass Winthrop) working as productively as ever. Vaccinations are gathering speed and restrictions are easing across the country. While we are by no means out of the woods, there are many reasons to be optimistic that life will improve in the months ahead. In this letter we explore whether or not the same will hold true for the financial markets.

Building demand and restricted supply could put upward pressure on prices

Speaking of the markets, who would have thought that the US economy would have experienced such a dramatic contraction, yet the major stock indexes would not only recover but reach all-time highs a year later? The return on the S&P 500 (including dividends) was a respectable 6.2% for the quarter ended, March 31, 2021; this brought the index's total gain to a remarkable 69.5% from its low on March 16, 2020, one of the steepest twelve-month climbs on record.[1]

The advances in stocks were due in large part to swift and unprecedented action by governments and central bankers around the world. The flood of liquidity that they released gave investors confidence that companies would have access to enough low-cost capital to get through the economic downturn brought on by the pandemic. In addition, much of it flowed onto household balance sheets and some sloshed into the financial markets, lifting stocks. In a year where unemployment soared and many small businesses shuttered, combined personal savings rose by $1.3 trillion and consumer net worth rose 10% to an all-time high of $130 trillion.[2] All of this liquidity may fund an enormous bulge of pent-up demand, the release of which could catalyze extraordinary levels of production and drive the dramatic economic recovery that the surging stock market has foretold.

The image of the massive containership Ever Given blocking the Suez Canal for nearly a week in late March became an instant sensation, emblematic of stalled global commerce. With many overseas economies still closed or stunted, raw materials and other input shortages are becoming increasingly problematic. **Nike**, a company we admire for many reasons including its usual mastery of supply chain management, reported robust demand in its most recent quarter, but sales fell 10% short of expectations because of shipping-related backlogs. Perhaps the most troubling supply chain disruptions are in the semiconductor industry, where plant fires, transportation bottlenecks and trade policy have led to an acute global chip shortage, which is affecting the production of everything from consumer electronics to automobiles. For example, **Ford** announced that it is cutting production of its prized cash cow, the F150 pickup truck, due to a dearth of semiconductor-based components.

According to one of the basic tenets of economics, prices tend to rise when demand exceeds supply. One can see this dynamic in action in all sorts of markets, from commodities like oil to housing. In February, the inventory of homes for sale in the U.S. fell 30% compared to February 2020 and average selling prices rose by more than 16%.[3] Headlines such as this became more frequent in early 2021 *before* the passage of the American Rescue Plan Act of 2021, President Biden's $1.9 trillion stimulus package which, though welcome by the majority of Americans for a host of reasons, has the potential to make supply and demand imbalances even more severe in the months ahead.

A nervous bond market impacts stocks

Inflation fears rattled the bond market during the first quarter, pushing 10-year Treasury yields from below 1% at the end of last year to 1.75% in March. But let's keep things in perspective: even with that recent spike, real rates (after adjusting for inflation) across much of the Treasury yield curve are zero or negative as the second quarter gets underway. Moreover, the Federal Reserve has made it clear that it remains a buyer of a wide assortment of bonds to keep liquidity flowing and both real and nominal interest rates low by historical standards. Should economic activity accelerate as most observers (including us) anticipate, we would not be surprised to see interest rates rise further, although probably not to the extent that some bond market bears are predicting. Putting aside the precision of any given rate forecast, in the short run we think there is more risk than opportunity in the bond market.

In addition to punishing bond investors, rising rates impacted the stock market's winners and losers in the first quarter. As treasury yields spiked, growth-oriented benchmarks such as the NASDAQ Composite Index experienced a notable correction, declining over 10% from its all-time high in February to its lows in early March. More speculative small capitalization growth stocks fell even further. Portfolio holding **Spotify** is an example of a company whose shares soared in 2020 on its stellar long-term growth prospects. The stock gave back some of those gains in the first quarter of 2021 as rates rose, even though the company's dynamic fundamental story continued to improve.

In contrast, so-called value stocks including banks (such as **J.P. Morgan**) and cyclical industrials (such as **Deere**) performed relatively better. J.P. Morgan's non-lending segments registered particularly strong growth, while rising rates buoyed the prospects for its loan book. Deere raised its profit guidance for the year by 25% amid a surge in orders, as rising crop prices easily justified the beginning of an overdue replacement cycle for high performance agricultural equipment. We think the rotation into value and out of growth has further to go, and we continue to concentrate our research efforts on identifying companies whose shares are inexpensive relative to their improving fundamental prospects.

Looking ahead, inflation and interest rate fears are likely to compete with concerns about the impact of proposed tax increases as investors' top worry. The Biden administration and its allies on Capitol Hill are attempting to raise funds to address a host of priorities including ailing infrastructure, climate change, and education reform. Their biggest target is corporations, through an increase in statutory rates and changes in the treatment of international income. Economists are forecasting a 7% average reduction in after-tax earnings for the companies in the S&P 500 in 2022 should the administration's proposal to raise the corporate tax rate to 28% pass. With so much pent-up demand and a better-than-expected vaccine rollout underway in the U.S., we still hold a positive outlook for stocks over the long haul, but we expect more volatility in the short run. At Douglass Winthrop, we embrace such short-term swings in sentiment and price, as they provide opportunities to buy shares of companies whose long-term outlook is bright despite potential near-term headwinds.

Long-term portfolios with a different perspective

Those looking to make a quick buck on a popular trade should look elsewhere when selecting an asset manager. Our long-term outlook and urge to challenge consensus thinking are central to Douglass Winthrop's approach. When we purchase a company's shares, we intend to hold them through a number of business cycles. We seek the highest quality companies based on criteria that make for reliable overachievers: sustainable competitive advantages, abundant free cash flow and low debt, opportunities to reinvest earnings profitably, and led by management teams who invest capital wisely. Finding firms that meet our high standards at attractive prices is always challenging. Success requires a variant perception about a company's prospects and the conviction to be patient as our theses play out. **Fastenal Co.** and **Mettler-Toledo** are two industrial holdings that underperformed for a period after we added them to our portfolios, but eventually rewarded our patience and variant perceptions with market-beating returns.

Fastenal distributes a wide range of industrial fasteners, tools and other building supplies. In recent years the company has emphasized operations within its clients' facilities (including vending units) over deliveries from its many branch locations. This strategic shift ensures

steady revenue streams through longer-term contracts and high switching costs, as clients are unlikely to halt operations to find a new in-house supplier. The industrial vending market is estimated to be $25 billion per year, and Fastenal is quickly taking share. Some 50% of the company's $6 billion of 2020 sales came from vending, and its sales force has been converting clients into "Onsite" accounts at a 40% compound annual rate over the past three years. Some are worried about the temporary compression in gross margins that comes with a shift to the more expensive Onsite model. Longer term, we see operating profit margins expanding as selling expenses and overhead decrease once a vending unit is in place, more than offsetting the narrower gross profit. We also believe that a greater share of the overall market for tools and supplies can convert to the vending model over time, giving this innovative leader an under-appreciated growth opportunity for years to come.

Mettler-Toledo is the global leader in precision weighing and inspection equipment. These products find use everywhere from research labs and drug manufacturing facilities to metal production and supermarket checkout scales. Though many of Mettler's end markets are small and relatively mature, it typically dominates them, with 75% of its products commanding first place market share. This creates a considerable competitive advantage: larger tools manufacturers are unlikely to find these smaller niche markets sufficiently attractive, while smaller players are unable to compete with Mettler's lower production cost, research & development investments, and extensive service offerings. Mettler has consistently taken share and raised prices (+2.5% compound rate) over the past two decades. Others may wonder if the company's growth prospects justify the stock's premium valuation. We see opportunity for Mettler to expand in emerging markets and to continue its successful track record of finding efficiencies and tuck-in acquisitions to drive well-above-average earnings growth for years to come.

A firm with a long-term view to match

At Douglass Winthrop we also have a long-term view when it comes to our own business. We constantly invest in our infrastructure and team to better serve our clients. During the quarter we began implementing a new CRM system to help organize client information, making it easier to securely access data to meet client requests. On the personnel front, we added additional operational resources as we welcomed Assistant Client Relations Manager **Danielle DiMaria** and Chief Operating Officer **Andrew Weinberg** to our team. Andrew brings a wealth of experience to Douglass Winthrop, having worked for more than 30 years at financial institutions in New York, Boston, London and Stamford. Andrew succeeds our partner Chars Crane, who has assumed the role of Head of Business Strategy and Development. We also reached an important milestone for our Environment Strategy, which surpassed $100 million under management. Our performance-first philosophy and process has produced strong results, and we encourage those who are interested in sustainable investing to reach out to us to learn more about our unique and authentic approach.

In a year that was so notable for heartache and challenges, we consider ourselves very fortunate to be stable and growing. Our gratitude for this success rests squarely with our clients, who have trusted us as stewards of their portfolios through this unpredictable period. We hope we will continue to earn your trust through whatever challenges may lay ahead, and we wish you a healthy and happy spring.

Sincerely,

Douglass Winthrop Advisors LLC

Please see endnotes and important disclosures on the following page.

[1] All market data: Bloomberg.

[2] Strategas, Investment Strategy Report, March 26, 2021.

[3] National Association of Realtors.

[4] Interest rate data: Bloomberg.