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Dear Clients and Friends,

Long before Tom Slick was known as "King of the Wildcatters" he prospected for oil without success across the American west, losing financial backers and earning the moniker "Dry Hole Slick." Undaunted, Slick settled in Cushing, Oklahoma where he leased land belonging to rancher Frank Wheeler and drilled anew. On March 12, 1912, he struck a large gas deposit, sending crude oil five stories in the air and turning tiny Cushing into a magnet for speculators, wildcatters and bankers chasing instant riches in the oil patch. As it happened, production peaked in Cushing in 1916 but by then the town had become a center for refineries and, eventually, pipelines. Which is why, just over a century later, Cushing was once again ground zero for the oil business.

Most supplies of U.S. crude oil are stored in Cushing, known today as the Pipeline Crossroads of the World, because it is the terminus of pipelines from the western U.S. and Canada and has over 90 million barrels of storage capacity. So much oil flows through Cushing, in fact, that it is the reference point for West Texas Intermediate Crude (WTI) prices, which have fluctuated between about $20 and $100/barrel since 2000. On April 20, 2020, for the first time in history, futures contracts for WTI plunged 300%, from $17.85 to *negative* $37/barrel, as demand for oil evaporated, storage tanks filled to capacity and U.S.-bound oil tankers floated off the California coast with nowhere to offload their cargo.

As COVID-19 ravaged communities across the country, so too did it take a toll on commerce, from restaurants and retailers to financial markets and global corporations. Amid the wreckage of this challenging year, it seems worthwhile to consider the factors that helped some companies survive and even prosper while others face a long and uncertain road to recovery.

Beware value traps (Sometimes it's what you *don't* own that matters)

Energy bulls cite the abrupt economic downturn from COVID-19 and a production agreement by OPEC and Russia as the main culprits for the April 20 oil price crash. While those factors surely battered futures markets that day, more enduring threats stalk the energy business. Changing regulatory and consumer attitudes toward fossil fuels and a glut of new supply from fracking and new technologies have made oil exploration more risky and less profitable. Companies long accustomed to paying generous dividends and funding profitable expansion projects now tap the debt markets to fund operations and placate shareholders. With stock prices for many energy companies down precipitously since the start of 2020, some intrepid value investors suggest a buying opportunity is at hand. We won't join them.

Price is a useful tool for buying or selling securities but it tells a thoughtful investor nothing about the intrinsic value of a business or the environment in which that business operates. For decades newspapers were exceptional businesses, generating high margins and recurring revenue from subscriptions and advertising. When the Internet emerged as a more efficient medium, newspaper stocks were decimated and these mainstays of value investing became value traps. Being in the right industry matters: even the best businesses can and will be destroyed by fundamental changes in their operating environment that have little to do with the quality of management or financial strengths of a particular company.

As value investors, we seek businesses in large, growing markets with recurring revenue, low capital intensity, high returns on equity, abundant reinvestment opportunity and a relentless focus on shareholder value. Sometimes investors assign relatively low prices for businesses with these attributes, as they seem to do now with companies such as **Nestlé** and **Berkshire Hathaway**. In contrast, **MasterCard** and **Alphabet** trade at above average multiples of earnings. Their moats and growth prospects, however, are improving in a global economy defined increasingly by digital commerce and information. We don't need to bet on commodity prices, interest rates or next quarter's earnings to know the odds are stacked in our favor as owners of these secular growth businesses. A closer look at **Costco**, which we have owned since 2016, provides a useful analog.

Costco: A durable moat and long-term growth potential

The leader in discount merchant clubs, Costco has established a durable moat in an industry where moats are scarce because customers experience very low switching costs when choosing where to shop. The sources of Costco's moat are its procurement strength, subscription-like membership model and reputation for quality, all of which are mutually reinforcing and drive repeat customers. Costco has grown annual earnings and dividends almost without interruption, and has significant growth potential in terms of international store expansion and investment in Kirkland, its private label brand that now accounts for roughly 25% of total sales. In 2020, a year in which many bricks-and-mortar retailers were decimated, Costco is likely to report growth in both e-commerce and on-site retail sales.

Customer value is an obsession at Costco. Like its far larger rival, Walmart, Costco has the scale to demand low prices from its suppliers. Costco stores, however, carry only 3,700 SKUs or so versus roughly 140,000 at Walmart. This more concentrated strategy allows Costco to achieve industry leading pricing and pushes its suppliers to innovate. Charlie Munger, Berkshire Hathaway's vice chairman and a longtime Costco board member, observed, "…when other companies find ways to save money they turn it into profit. [Costco] passes it on to customers. It's almost a religious duty, sacrificing short term profits for long term success."

The value of Costco's customer-first strategy can be seen in its membership model, which accounts for roughly 2/3 of operating income and provides the cash flow to compensate for razor thin retail margins and to invest in growth initiatives. The Kirkland private label brand, for example, now accounts for approximately $40 billion in annual revenue, more than the annual sales of Coca-Cola, and generates higher margins than branded products sold in Costco stores. Developing the Kirkland brand is an important growth opportunity for Costco, as is international expansion. In August 2019 Costco opened its first (and currently only) store in China in Shanghai, and was forced to close that day due to panic buying and massive crowds drawn by Costco's reputation for low prices and product quality. While the operating efficiencies Costco enjoys at its North American locations will be hard to replicate internationally, the room for expansion is vast. Of Costco's 795 locations worldwide, more than 650 are in North America, with none in South America, India, Africa or most European countries.

The strength of Costco's operating model is evident in its financial results. The company has no net debt and has increased earnings per share, dividends and revenue nearly every year as a public company. While the nominal yield is low, Costco periodically pays special dividends, most recently on December 11, 2020 when shareholders received $10.00/share – a remarkable achievement in a year that devastated many retailers. Costco shares do not seem as inexpensive as the products it sells to customers, but we have confidence in the company's defensive attributes and growth prospects in a global consumer economy where value, trust and quality are increasingly in demand.

Moving on from 2020

For many, 2020 was an exhausting year to be remembered mainly for COVID-19, which threw millions of Americans out of work and killed hundreds of thousands. A deep recession and tensions over social and economic divisions added to a sense of America at a crossroads. By year end, news that the FDA had approved two vaccines based on a novel messenger RNA technology felt to many like blue sky after a hail storm.

As in the country as a whole, fear and hope vied for the upper hand in financial markets throughout the year. After crashing in February, the S&P 500 recovered its previous highs, returning +18.4% including dividends for the year. The Russell 1000 Value index returned just +2.0%, extending the performance gap between so called value and growth stocks. The stocks in the DWA Total Composite compared very favorably against the Russell 1000 Value, returning +17.6% (gross of fees) and 16.8% (net) for the year. Performance aside, it is worth underscoring the advice we shared with clients in March as the stock market was plunging on fears of the virus and its economic fallout. We expressed confidence in our portfolio companies and noted that stocks would recover before the news improved. Staying invested in times of crisis is hard, and we are reminded that the businesses we own are tough adversaries for even the scariest threats.

Looking ahead, it seems many investors have veered from panic to exuberance. The economic backdrop is benign for stocks, with interest rates barely above zero, two vaccines in distribution and expectations for a robust economic recovery in 2021. However, consensus in investing is a dangerous thing and it often pays to take the other side. Bond investors won't continue to finance America's yawning deficits at paltry interest rates indefinitely without evidence of discipline in fiscal policy. Unemployment may prove deeper and more persistent than some expect, and the euphoria at having vaccines, miraculous in their speed and efficacy, may be tested in the months ahead. Risk is always with us, the risks we expect and those that come out of nowhere. Our advice is to stay invested in businesses with above average prospects for preserving and growing value, no matter the environment.

Internal update

In spite of the challenges of working remotely, Douglass Winthrop Advisors LLC ended 2020 in excellent shape as a business, thanks in large measure to the efforts of our client relations team. Assets under management reached approximately $4 billion and our Environment Strategy and institutional outreach are off to encouraging starts. As mentioned in earlier letters, we welcomed two terrific colleagues to the firm in 2020: Dan Abbasi to lead our Environment Strategy, and Mabeth Vicera, who joins our exceptional client relations team, reporting to Rossana Azzara. We are thrilled to report that Rossana, our first employee and our partner in every important respect, has officially joined the partnership effective January 1, 2021.

To our clients, we are pleased to enclose your year-end 2020 appraisals, realized gains and losses reports and performance summaries. Please accept our best wishes for a safe and happy 2021 and let us know if we can be helpful with any matter, financial or otherwise. In this year of loss and despair for so many, our thoughts are with those less fortunate, even as we send heartfelt thanks for your support and confidence in our firm.

Sincerely,

Douglass Winthrop Advisors LLC