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Douglass Winthrop

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Dear Clients and Friends,

The past few weeks have been among the most tumultuous in memory. The impact of COVID-19 and the measures implemented to combat its spread have upended any sense of normalcy and brought the global economy to a standstill. We are battling the stark reality of a health crisis where our families, friends and colleagues are falling ill with a disease for which no treatment nor vaccine yet exists. Though the majority of the population will stay healthy, these are frightening times requiring significant sacrifices by all. At Douglass Winthrop, our focus has been on how current events are impacting our clients' portfolios, assessing risks and identifying opportunities as they present themselves during this unprecedented global emergency.

Hope for the best but plan for the worst

Despite shelter-in-place orders that have shuttered so many companies both big and small, our firm is open for business and is operating smoothly. Thanks to extensive business continuity planning, technology investment and, most importantly, the adaptability and efforts of our team, we have been able to maintain all phases of our operations with little interruption, providing the high levels of service our clients have come to appreciate, especially in the most challenging of times. Although deprived of in-person contact with clients and colleagues, we have never been more engaged.

The financial markets have rarely been more volatile. The S&P 500 fell almost 20% in the first quarter, its worst quarterly retreat since 1987. The peak-to-trough decline was even more dramatic: from February 19th through March 23rd, the Index dropped 35%, the fastest decline of that magnitude on record. As painful as it has been, the sell-off in stocks seems justified given the disruptions and uncertainty we are all experiencing. Stocks surged in 2019, with the S&P 500 posting total returns in excess of 30%, driven by expectations of solid earnings growth and mild inflation in 2020. It is now likely that profits will decline this year, perhaps sharply. As if the virus containment efforts around the world were not enough of a shock, Saudi Arabia and Russia initiated a price war in February that has sent the price of oil plummeting by more than 50%. Although lower oil prices help consumers of the commodity, many U.S. producers could be driven out of business if current prices persist, with negative effects rippling through the banks that finance them and other businesses that serve them. The bond market is pricing in a severe recession, with 10-year Treasury rates of just 0.7% as of the end of March. Some pundits are predicting a depression akin to that which gripped the world in the 1930s...or worse.

We respectfully disagree. The contraction in domestic and global business activity will no doubt be severe in the next couple of quarters, perhaps the worst such period on record. In the last two weeks in March, nearly 10 million Americans filed for unemployment benefits, and millions more are likely to follow in the weeks ahead. But our economy was in good shape before the coronavirus outbreak, with low unemployment and healthy household and corporate balance sheets. We see little value in predicting its exact shape nor the precise timing of its commencement, but we are confident that an economic recovery is in our future.

Help is on the way

Governments and central banks are responding to the crisis with unprecedented stimulus. In a heartening sign for those disillusioned by partisan rancor, a bitterly divided Congress came together with the White House to pass an historic $2.2 trillion aid package in an effort to blunt the impact on individuals and corporations. The bill contains aid for healthcare providers, direct payments to consumers, small business loans that convert to grants for those firms that keep paying their employees and a host of measures to support the most affected industries. The ink is barely dry on this bill and already there is talk of additional fiscal stimulus. Such enormous spending is unprecedented in peacetime, and will be financed with a surge in government debt. By slashing rates to zero, the U.S. Federal Reserve Bank has at least minimized the interest on new short-term debt. "Whatever it takes" is the Fed's new mantra when it comes to supporting the economy and protecting the banking sector to keep credit flowing.

Predicting the pace of economic activity is never easy. Compounding that challenge today is the fact that no one knows how long the restrictive measures imposed to contain the spread of COVID-19 will last. There simply is no playbook for such an unprecedented event. Visible human costs like those seen in New York and other hard hit areas may dull our impatience to rush back to normal. When social distancing recommendations are lifted, a phased restart to the economy is likely, leaving certain industries such as travel and entertainment exposed for longer than those that do not require close physical contact.

One bright spot is the digital economy, where activity is expanding by the minute. Technology investments made over the past 25 years that enable us to see our doctors remotely or to work, learn, socialize and order necessities from home are enabling the fight against COVID-19. Adoption curves are steepening as consumers across all age groups are going online rather than leaving their homes. How many of us have recently had video chats with our doctor or enjoyed an online exercise class for the first time? DWA portfolio companies including Google, Microsoft, Charter Communications and Amazon are examples of those that will benefit from our accelerating digital evolution.

Conversely, international commerce is likely to be negatively affected. The postponement of the 2020 Olympics, globalism's signature event, is an ominous harbinger of growing concerns with interconnected economies. With scarce resources to share, countries are looking inward, reassessing the wisdom of global supply chains and interdependence. For example, European integration has likely taken a giant leap backwards as each country charts its own course during the pandemic. Companies that rely on low-cost labor and inputs from overseas to support margins, such as Nike, Apple, and Fastenal, may face challenges that extend well beyond the current crisis, and we are weighing such risks when evaluating these holdings.

Confident in our portfolio…

When COVID-19's threat reached our shores and the stock market tumbled, we responded in our role as portfolio managers the same as we do each day: calmly measuring the risks and opportunities of every position for every client's specific needs. We had already done the hard work of building a resilient portfolio of companies that can weather economic downturns, even one as severe as this. Each of our approximately 30 stocks earns its way onto our buy list after a comprehensive vetting process using our five filters. Each possesses a wide economic "moat" or barrier to potential competitors; pristine financials, including a strong balance sheet and stable cash flows; a management team with a proven track record of making wise capital allocation decisions; abundant reinvestment opportunities to grow their business; and finally, a price that offers an above average appreciation potential and modest downside risk, in our opinion. Our research team constantly reevaluates each stock in our portfolio, selling a company's shares when something fundamental about its business changes for the worse, the price exceeds our internally derived estimate of fair value, or we see a better opportunity in the shares of another company. Core holdings such as Nestlé, Becton Dickinson and Microsoft have survived this process for many years, as has Berkshire Hathaway, which has been in the portfolio since our firm's founding in 1999.

…but never complacent

As the magnitude of the threat posed by COVID-19 became more apparent and stock prices tanked, we did not sit on our hands, complacent in the belief that the stocks we owned at the beginning of the year still represented the best potential for future investment returns given the sudden change in the global business landscape. Taking a cue from Jack Welch, the former CEO of General Electric who passed away during the quarter and was infamous for his policy of replacing the bottom-performing 10% of GE's managers each year, our portfolio turnover has increased substantially in March and early April. We have been working overtime to identify better opportunities in a market that has indiscriminately hammered the shares of some great companies that we have long admired but were too expensive.

Early in the quarter we removed Disney (DIS) from our approved-to-buy list following the successful launch of its content streaming service, Disney+. We felt that the shares reflected an abundance of good news, and that executing plans to change its content distribution to a direct to consumer model would be fraught with potential missteps. Disney's plans to fund investments rely on cash flow from its popular theme parks that had already begun to show weakness in Asia as early as January. Perhaps former CEO Bob Iger agreed, considering that he announced his retirement shortly after our sale. More recently, we took United Technologies (UTX) off the list after it failed to live up to our expectations. UTX spent billions on a costly but ineffective restructuring program aimed at unlocking the value of its disparate operating units. More importantly, its main business lines, aerospace, HVAC, and elevators are heavily exposed to end markets that will experience sharp demand drops in a recession.

We see a more attractive outlook for the shares of Monster Beverage Corporation (MNST) which are trading at a low P/E ratio relative to its history and that of its competitors. Monster earned its way onto our approved-to-buy list after posting an impressive compound annual earnings growth rate of 23% over the prior three years. Guided by a management team which has been together for 28 years, this market leader in the fast growing energy drink segment boasts robust cash flows as a result of high margins and has a pristine balance sheet it can use to its advantage to capture market share in a downturn.

Another recent addition to our approved-to-buy list, Amazon (AMZN), has long earned our admiration as a well-run business with near infinite growth potential. Amazon's scale and execution experience sets it apart from other ecommerce and cloud computing companies. Though Amazon's share price has not declined at the same rate as the market, current levels still make a compelling investment from a valuation standpoint with shares trading well below Amazon's 10-year average enterprise value to EBITDA ratio.

Douglass Winthrop updates

We are excited to announce that Dan Abbasi has joined the firm as a Managing Director to strengthen the firm's Environment Strategy, which now has three full years of investment results. Dan's background at the intersection of business and the environment spans leadership roles in investing, manufacturing, academia, the non-profit sector and the Federal government. More on Dan's background and the Environment Strategy can be found on our website, www.douglasswinthrop.com. We are also pleased to announce the addition of Mabeth Vicera to our Client Relations team. Mabeth joins us from the High Net Worth department of Fiduciary Trust Company International where she served for 10 years. These additions illustrate our commitment to strengthening our firm to meet our clients' needs.

Douglass Winthrop

As a small sign that necessity - the mother of invention - is hard at work these days, many of our clients are receiving their quarterly statements and this letter electronically for the first time due to the logistical challenge of producing and mailing printed statement packages while our team works remotely. Our goal is to transition 100% of our client communications to digital distribution, leading to faster delivery and allowing us to do our part for the environment, both positive changes that will stay with us long after the current crisis recedes.

In closing, no one knows when the stock market will bottom, or indeed if it already has. History tells us that markets tend to reach their lows well in advance of the end of a crisis. With this in mind, we believe that those with cash to invest for the long-term should prepare to deploy it, albeit with a measured approach. With visibility comes confidence and, as we gain a better understanding of what lays ahead, volatility will eventually ebb and stocks should rebound.

We wish to express our sincerest gratitude to our clients, whose trust makes our work possible. We hope that the impact of this virus ends up being merely a delay to your important life plans. We encourage you to engage with us and to allow us to help you navigate these daunting times. Although the past month has been challenging in so many ways and there may be even more difficult times ahead, we are steadfast in our conviction that we will get though these trials together and will be stronger for it. Be safe, and be well.

Sincerely,
Douglass Winthrop Advisors

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