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**Douglass Winthrop**

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Dear Clients and Friends,

In 2011, Morgan Stanley published a research report on the future of electric vehicles. To illustrate the point that changes in consumer behavior happen more quickly and with greater disruption than expected, the report included two photographs of Fifth Avenue in New York City taken in 1900 and 1913, respectively. The first photograph shows a single car surrounded by a multitude of horses, while in the second all the horses are gone, replaced by cars. The decades ahead will bring advances in transportation, artificial intelligence ("AI"), healthcare – and the pace of change may accelerate from what we are used to. Consider that five of the eight largest companies by market cap didn't exist 25 years ago. According to Realclearscience.com, an iPhone has more than 100,000 times the processing power of the NASA computer that landed Apollo 11 on the moon, and enables communication, work and entertainment on a scale our grandparents could scarcely have imagined. While society's problems are immense and the benefits of humanity's progress are distributed unevenly, one is awed by the power of innovation to drive radical change.

Fueling much of this innovation is a vibrant global capital market and an American economy that leads the developed world in size, projected growth and employment. At eleven years, the current expansion is the longest ever recorded. Corporate profit margins and share prices are at record highs, shrugging off impeachment, rising tension in the Middle East and an ominous yield curve, which inverted briefly last year. Expanded valuations accounted for virtually all the stock market's return in 2019, eclipsing profit growth, as investors rushed to own risk assets. With 10-year Treasury yields under 2%, the price to "earnings" ratio of risk free bonds is over 50x. Capital markets activity is surging with large deals announced by Bristol-Myers, United Technologies and AbbVie, and the initial public offering of Saudi Aramco, which valued the oil behemoth at $1.7 trillion. The world is awash in capital and asset prices are soaring. Look closer, however, and concerns are mounting, two in particular.

### "You don't need a weatherman to know which way the wind blows"

Bob Dylan wasn't referring to the stock market but his observation that some facts are readily apparent is apt today. Start with the economy. Credit for much of the current expansion is due to a binge of federal spending, funded by massive Treasury bond issuance at historically low yields. The $23 trillion in Treasury debt outstanding now exceeds our nation's economic output, and the Congressional Budget Office projects a deficit in 2020 of more than $1.0 trillion. No effort has been made to address deficits or restructure mandatory spending programs, mainly

Social Security and Medicare, which account for nearly 50% of the federal budget, followed by defense and interest on Treasury debt. Longer term, the consequences of profligate spending and borrowing include higher interest rates, inflation and a "crowding out" effect on private capital formation. Alarm bells sounded by the likes of Pete Petersen, Erskine Bowles and Alan Simpson seem quaint, if recognizable at all, to a political class motivated mainly by re-election and political theater. A fiscal time bomb lurks.

Debt is not the only economic threat facing the U.S. A worsening trade war with China and the partition of the world into semi closed trading blocs are likely to constrain economic growth and competitiveness at precisely the moment the world needs American economic leadership. As the global economy transitioned from horses to cars at the dawn of the last century, so too are the world's leading economic powers now grappling with massive change brought on by climate change, AI and the rise of China. Already, China is the world's largest market for electric vehicles, and has massively greater investment in high speed rail, clean energy production and 5G technology than does the U.S. A trade policy built mainly on tariffs for industries such as steel, autos and agriculture has domestic economic and political advantages, however it imposes costs on consumers and importers, and distorts the efficient flow of capital and labor. Current trade policy risks sidelining the U.S. at a moment of maximum change and opportunity for the world's leading economic powers.

Managing these fiscal and strategic challenges will require political courage and decisive action, with attendant risks and opportunities for investors. Because we expect aggregate stock market returns to be modest in the medium term, a disciplined and thoughtful investment process will be, as always, critical for investment success.

## Value Investing: A Dynamic Model

Value investing is a widely used term without a commonly accepted definition. Benjamin Graham believed the purpose of value investing was to invest in stocks when the market price represented a material discount to a company's intrinsic value, conservatively determined in relation to book value and reported earnings per share, a condition Graham referred to as a "margin of safety." Warren Buffett and his partner at Berkshire Hathaway, Charlie Munger, adapted Graham's model by relaxing the valuation standard and being willing to own businesses with high returns on equity and above average growth prospects, even if they weren't available at Graham's statistically cheap prices. Berkshire's investments in Coca-Cola, Moody's and Apple exemplified this change. For both Graham and Buffett, valuation was a primary factor in selecting securities.

At DWA our research aims to discover shareholder-oriented business possessing wide economic moats and abundant reinvestment opportunity, available at reasonable valuations. If Graham's (and to a lesser extent, Buffett's) most important consideration was valuation, ours is the quality of a business. We seek to ascertain the intrinsic value of a company using traditional valuation and accounting metrics, however our primary goal is to identify companies that address huge, global markets with a commanding and defensible market position. A long term investment horizon is a significant advantage, enabling us to hold investments through periods of temporary overvaluation and to act when short term news affects market prices. **MasterCard** and **Alphabet** appear expensive on traditional valuation metrics (e.g., book value, reported earnings) but the addressable market for both companies is massive and growing, and we believe management can reinvest capital at high rates, ensuring long term earnings growth. Likewise, **Nestlé** is transforming its business by investing in the fastest growing parts of the global food business while making large investments to gain market share in developing countries. Such investments depress near term earnings but are likely to enhance Nestlé's competitive position and growth prospects. **Berkshire Hathaway** itself is stockpiling cash at a rate of $2 billion/month, perhaps in anticipation of making a large acquisition the next time asset prices fall. In these examples, we view the quality and durability of each business, more than the valuation of the stock, as our margin of safety.

In a global marketplace characterized by rapid technological change, lightning fast dissemination of information and winner-take-all markets, traditional valuation analysis is insufficient to identify great investments and determine a margin of safety. Many of the world's leading companies are comparatively young and asset light, meaning traditional accounting metrics such as fixed assets, reported earnings and book value can give misleading pictures of a company's ability to grow, defend market share and generate high returns on equity. Our investment team brings a diverse set of perspectives and experiences to the analytical function at DWA, supporting a dynamic model for value investing that we believe is required to navigate the risks and opportunities ahead.

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## Looking Ahead to 2020

Our approach has delivered strong results historically. In fact, the equity component of our Total Composite has outperformed the S&P 500 Total Return and Russell 1000 Value Total Return indexes for the past one, three, five and ten years, and since inception (2006). In 2019 this measure returned +35.9% (gross of fees) vs. +31.5% and +25.6% for the same indexes, respectively. Our best stocks were Apple, Martin Marietta Materials and MasterCard while our least strong contributors were Markel, Unilever and Berkshire Hathaway.

Under the capable leadership of our partner, Mary Kush, we have launched an effort to serve institutional investors, including investment consultants, family offices and outsourced chief investment officer ("OCIO") firms. Our results are now live on eVestment and other databases used by these investors and we are hopeful that DWA will be successful in addressing this important market in 2020.

To our clients, we are pleased to enclose your performance history, appraisal and draft realized gains and losses for the year ended December 31, 2019. As we say frequently in these letters, we are grateful for your confidence in Douglass Winthrop Advisors LLC and keenly aware that you are the reason for our success as a firm. The steady growth in our client base has enabled us to hire the best people available, which in turn strengthens our investment process, wealth advisory capabilities and client service team. A heartfelt thanks to you as our firm enters its third decade.

With gratitude and wishes for a happy New Year,

The Douglass Winthrop Advisors LLC team

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