Douglass Winthrop Advisors, LLC
535 Fifth Avenue 22nd Floor
New York New York 10017

New York
Boston
Washington, D.C.

Telephone 212 557 7680
Telefax 212 557 7683
douglasswinthrop.com

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Dear Clients and Friends,

We begin our commentary with the happy news that Pam Raviol and Diane Scarborough have joined DWA as Managing Director and Senior Client Relations Manager, respectively. Pam and Diane bring to our firm distinguished professional backgrounds and a keen appreciation of the values and culture that define DWA. We are thrilled to welcome Pam and Diane and their terrific clients. To all our clients, we look forward to working with you in the years ahead. You are the lifeblood of our business and we are committed to earning and keeping your trust and confidence.

Good News Reflected in Asset Prices

A frequently cited difference between journalism and history is the lack of perspective available in real time news reporting. What seems of vital importance in the moment may prove less consequential when viewed in a broader historical context, and the opposite can also be true. Headlines from this writer's childhood, for example, were dominated by OPEC production quotas, arms reduction treaties and predictions of America's economic decline. Less widely covered were innovations in computing and energy extraction or the contrarian view that the Soviet Union would dissolve peacefully, contributing to a prolonged economic boom in the U.S. What to make of today's headlines including tax reform, an unconventional Presidency and the extraordinary rally in financial assets?

Economic data is robust, with employment surging, GDP growth surpassing 3.0% and the stock market hitting historic highs. The Trump administration has kept campaign promises to enact tax reform, exit trade pacts and roll back environmental regulations. Indeed, by withdrawing from the Trans Pacific Partnership and green lighting oil exploration in every coastal state and the north slope of Alaska's Arctic Refuge, the administration has signaled as sharp a change in policy as we can recall. For now, investors are ebullient. Last year the S&P500 returned 21.8% including dividends without a single down month. [1] Investors who bought the index at the end of 2008 and held for the ensuing nine years have a gross return of 3.6x. [1] Interest rates remain stubbornly low despite the Federal Reserve's pivot toward tighter monetary policy, and inflation is subdued. At over eight years in duration, the current expansion is among the longest on record.

[1] Source: Bloomberg L.P.

We believe this enthusiasm is overdone, and that near term returns will be below average from these levels due mainly to valuation and economic factors that are insufficiently discounted in equity and debt markets. Earnings growth has been exceptional, and valuations have climbed even faster. At year end 2017 the five largest stocks in the S&P500, representing $3.5 trillion in market cap and 14% of the index, were Apple, Microsoft, Alphabet, Amazon and Facebook – all technology companies with p/e ratios over 30x trailing earnings (except for Apple, at 19x). History suggests today's leaders may struggle to maintain growth rates and hence valuation, due to regulation, competition or difficulty in adapting to new markets. Bonds are no more enticing with the 10-year Treasury yielding 2.4% [1] and spreads tight for less creditworthy issues. The Federal Reserve has indicated its intention to raise short term rates and unwind its bond holdings. While the pace of rate increases is expected to be measured, rising inflation could force the Fed's hand. A combination of higher interest rates, rising inflation, an economic slowdown or an unexpected geopolitical incident could cause valuations to reset.

In addition to valuation, longer term economic factors suggest the euphoria gripping financial markets may be fragile. The tax reform law includes pro-growth provisions relating to corporate tax rates and repatriation of foreign earnings, however it does not address deficits, which are poised to rise with higher interest rates and mandatory spending programs. Protectionist trade policies offer short term advantages to domestic companies but are sure to harm the competitiveness and growth prospects of US industry over time. Broadband and transportation infrastructure has been neglected, and federal priorities to support fossil fuel investment are at odds with those of most major economic powers. Geopolitical factors bear watching as well. Much attention is given to North Korea and Iran, deservedly so, but managing the emergence of China as a strategic adversary will likely vie for attention with the economic decline of Russia in the years ahead.

Value Matters

The unsettled economic environment is well suited to our firm's approach to portfolio management grounded in the principles of global value investing. As our clients understand well, we make long term investments in companies with wide economic moats run by shareholder oriented management. Most of our companies generate recurring revenue and free cash flow with low capital intensity and abundant opportunities for reinvestment. Our investment horizon is long, giving us the time to assess the intrinsic value of our companies and the confidence to endure periods of undervaluation. We do primary research, eschewing the sales and activity driven culture of Wall Street. And we invest alongside our clients, keeping our focus on capital preservation, tax efficiency and liquidity.

[1] Source: Bloomberg L.P.

Currently, we are weighing valuation heavily in our research process. Two areas of potential value we perceive are 1) mid cap companies with unassailable market positions protected by high switching costs, patient shareholders and low capital requirements, and 2) large cap, global companies with the scale, time horizon and strategic imperative to invest aggressively in emerging markets.

Discovery Communications (NYSE: DISCK) is an undervalued media company that is overlooked by investors chasing more glamorous stocks. Last year investors punished DISCK because it was perceived to be vulnerable to cord cutting, to have non-essential content and to be overpaying for Scripps Network Interactive (NYSE:SNI). We draw a different and more optimistic conclusion. Considering valuation first, DISCK traded recently at 8x earnings and we expect its acquisition of SNI, with 12.5% free cash flow margins, to be highly accretive as the deal is funded mainly with low cost debt. SNI gives the combined company a leadership position in non-fiction programming, implying greater leverage with distributors and advertisers. Discovery owns its content and benefits from a relatively low cost of production. Overlooked by many investors is Discovery's growing international footprint in subscription TV and online streaming. Through a majority ownership stake in EuroSport the company has exclusive rights to broadcast the Olympics, all four tennis slams, soccer and cycling races in certain countries. In the near term management's priorities are to reduce debt and consolidate the SNI operations. Longer term, we expect management to resume share repurchases and continue its international expansion.

International growth is one of our priorities as we evaluate prospective investments. Last year in this letter we shared our view that beer is a uniquely good business, highlighting Heineken and Anheuser-Busch Inbev S.A. (NYSE: BUD) as two of the best positioned global brewers. A close look at AB Inbev reveals a compelling investment thesis around that company's financial scale and strategic focus on emerging markets. AB Inbev owns seven of the top ten beer brands globally, including Corona, Stella Artois and Budweiser, earning two-thirds of its revenue outside the U.S. with huge market shares in developing countries. Sub-Saharan Africa, with a volume growth rate 3x that of the global rate, [2] is among the highest priorities for the company. Last year's acquisition of South Africa-based SAB Miller has produced cost savings well ahead of plan and positioned the company as the dominant brewer in Africa. Scale is a primary advantage for AB Inbev in producing, distributing and marketing in regions that are uneconomic for less well capitalized competitors. The company is now investing in production facilities in Nigeria, introducing its global brands in South Africa and offering innovative packaging for less expensive local brands in smaller markets such as Zambia. With EBITDA margins approaching 40%, the company has the financial strength and management skill to invest patiently in the most promising markets while returning capital to shareholders via dividends and capital appreciation.

[2] Source: Financial Times

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Business and the Environment

AB Inbev has developed the ability to make a unit of beer with less water than any other brewer, which is a significant competitive advantage in a world of scarce water resources. For this and other reasons the company is a core holding in our Environment Strategy, which we launched last year in response to certain clients' desire to align their portfolios with their concern for environmental issues. We have long resisted socially responsible investing ("SRI") because of the inherent subjectivity of many SRI strategies and the belief that our ethical values should not take precedence over those of our clients. Optimizing risk adjusted returns is our mandate, whether in our core or environment strategies. For these reasons, we launched the environment strategy to invest in companies that already meet our strict criteria for economic moat, management quality and financial strength – and are addressing large potential markets for environmental services including water scarcity, food security, deforestation or climate. Private sector capital will play a significant role in resolving these issues and we believe the best positioned companies will generate faster revenue growth, earn higher margins and attract better employees – all of which translate into competitive investment returns. Please let us know if this approach might be of interest to you for a portion of your assets.

New Chapters

Last year was an extraordinary year for DWA in many respects. Assets under management surpassed $2.0 billion and investment results for our clients were among the strongest in our firm's history. We welcomed new colleagues and established a Board of Advisors. As we turn the page on a busy and prosperous 2017, we are pleased to report that our friend and co-founder, Robert Douglass, will be relocating to Florida, where he will lead our business developments efforts there and continue serving as relationship manager for certain clients. Happily for us, Robert will be in New York frequently and remains a partner in the firm.

We bid adieu to Lisa Wade, who is retiring after ten years at DWA. Our clients know Lisa and appreciate, as do we, her tireless devotion to detail and to doing first rate work. Rossana, Meg and Diane will be supporting all of our clients as we seek a replacement for Lisa.

At the start of 2018 we appreciate the opportunity to do meaningful and challenging work, and are grateful to our clients for their steadfast trust and support. Happy New Year to all.

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