July 12, 2021

Dear DWA Clients and Friends,

We are pleased to offer a few perspectives on the market, our investment decisions, and our firm. For our clients, we enclose your quarterly package of portfolio reports.

Douglass Winthrop continues to grow and prosper. Our strength as a firm is rooted in civility and respect across our DWA family, which includes our team members, clients and friends. Our work is always challenging but intensely satisfying thanks to all of our partners, including you.

**Green Shoots of Progress Amid the Macro Weeds**

Following a year of dreadful news, the second quarter saw surprisingly favorable developments on the COVID-19 front. Cases and deaths dropped rapidly in areas of the country and the world where vaccinations have been widely administered. Businesses are re-opening and customers are lining up to spend the money saved during lockdowns. In London, Italy's national soccer team beat England's in a nail-biter of a final match for the European Cup in front of a live (and lively) crowd of 64,000 mostly unmasked fans. It is an exciting time and we can't help but marvel at the technological achievements that produced the vaccines in record time and the global cooperation that catalyzed them.

We believe the stage is set for a continuing and accelerating economic recovery and expansion. The sustainable fuels for an extended period of economic strength are abundantly present: necessity, productivity and re-investments by governments, corporations and individuals around the world. As always, leadership and governance will be critical.

There are some potential bumps along the way. We see the dangers of massive government debt sitting like a giant iceberg: current interest rates are visible above the water line but the potential full cost is hidden from view…and very dangerous. Inflation is another headline that has garnered increased attention this year. Our view is that the recent spike in prices is likely the result of a temporary supply and demand imbalance created by the pandemic shutdown and the surprisingly rapid re-opening.[1] The potential implications of various spending and tax policies put forward by the Biden administration has been another source of uncertainty. Infrastructure and social safety net proposals are being negotiated alongside new taxes on capital gains, corporate profits and generational wealth transfer. Furthermore, we see existential threats to economic and geopolitical stability from countries like China and Russia that are held together by force rather than bonded together through a democratic process supported by the rule of law.

When asked about our outlook on the markets we point out that (a) no one, including us, has a crystal ball and therefore trying to predict market moves adds no value; (b) nevertheless, a correction of 20%-30% is possible at any moment for any number of reasons; and (c) in our judgment, the best strategy to protect and to grow capital over the long-term is by assembling *and staying invested in* a high quality portfolio of public company stocks.[2] Valuations have gone up over the past decade and stand near all-time highs on a price to earnings multiple basis as well as other metrics. Although the low interest rates that presently prevail provide some measure of valuation comfort, there is less room for error when multiples are so high, and some caution is warranted. We believe that the best protection for investors in this environment is to own companies with large market opportunities that can grow revenues and earnings meaningfully over decades.

**Value Investing - DWA Style**

So how do we find such outstanding businesses? Our investment process begins with a fundamental analysis that seeks to identify the best combination of leadership, competitive strength, reinvestment opportunities, free cash flows and valuation relative to our growth expectations and risk assessment. Our five filter framework allows us to invest in a wide range of company profiles, some of which are considered “growth” companies. We are patient, disciplined investors and we consistently follow our process even when it is difficult and uncomfortable to do so. Over the past decade this approach has led to some notable shifts in our portfolios as we have adapted to changing opportunities and risks across our investible universe of companies. For example, we exited the fossil fuel sector entirely several years ago, concluding that the long-term returns on investment would likely never again be satisfactory, no matter how statistically cheap the stocks might seem. We also made more nuanced changes like selling American Express and buying PayPal as we reassessed the future of the financial services industry.

To highlight how our process flows from idea to conclusion, let’s examine some of the decisions that we have made as an investment team.

The first is our decision to invest in two banks at very different stages of development and future opportunity sets. **First Republic Bank** (NYSE: FRC) has consistently grown book value at the very un-bank-like rate of 13% per year over the past decade by focusing on a simple business proposition: build relationships with high net worth families to purchase homes in attractive and growing real estate markets. FRC has a service-centric business model that has earned them high customer satisfaction. We know the company well, since we work with them closely as clients and referral partners. The leadership of the company has been steady over the years with clear reporting, amazing financial returns and a strong credit culture. This is a growth company trading at a premium to the market and its peers, but we believe the multiple is justified and view the stock as a compelling value investment today.[3]

We also invested in **JPMorgan Chase** (NYSE: JPM) last year during the depths of the pandemic-fueled market sell-off. Its current leadership under CEO Jamie Dimon has been excellent, and shareholders have been rewarded with a 12.6% compound annual return (including dividends) over the course of his sixteen-year tenure (past performance is not a guarantee of future results). The business has a fortress balance sheet and strong free cash flows that can be returned to shareholders through dividends and share repurchases. Over the past decade, the company’s book value has grown at a compound annual rate of 6.6%, and the stock has consistently traded at a below-market multiple. When the stock declined by more than 40% from late February through March of 2020, we saw a compelling value and invested at what proved to be an opportune time. We expect profit and book value growth to slow in the years ahead, and valuation re-rating is unlikely to provide much of a lift. That said, JPM provides portfolio ballast that gives us greater freedom to pursue higher multiple companies like FRC.[4]

In our quarterly letters, we tend to focus on the stocks that make it in to client portfolios. Often it’s the stocks we *don’t* buy that contribute just as meaningfully to our absolute and relative performance (and sometimes more so). For every stock that we invest in, we scrutinize 5-10 companies that pass most—but not all—of our analytical filters. Some statistically attractive stocks are rejected because we cannot accurately assess regulatory risk. Others offer great financial strength but pay their executives exorbitant sums. And the shares of many great companies are simply too expensive and offer insufficiently attractive ratios of upside potential to downside risk. We keep those high-priced stocks on the bench, waiting for the time when that risk/reward ratio swings the other way, much as it did for JPM early last year.

The growth versus value debate is one that we are constantly engaged in. In our opinion, value investing is far more than a statistical exercise that favors lower multiples over higher. The best values are identified through an accurate assessment of future opportunities relative to known (and unknown) risks. Our process is designed to find value investment opportunities across the entire growth spectrum.

**Firm Update**

As we celebrate this 4th of July, we think about the benefits and challenges of various forms of governance. In both our investment work and as a shareholder-owned company, we believe deeply in the value of a merit-based system of representative self-governance. At DWA, we see each and every day how powerful an owner/operator-centric business is, and we are committed to remain independent as the next generations of DWA leadership ascend. Our goal is to continue to grow at a sustainable pace that allows our culture to flourish and our capabilities as a firm to increase for the benefit of clients, partners and our team. Our independence gives us our sense of identity, purpose and responsibility and allows us to adapt and to evolve, to become better and to welcome new people into our DWA family.

To this end, we are thrilled to welcome our newest teammate, Christina Zhang, as a research analyst primarily supporting our firm's Environment Strategy. Christina joins us by way of Columbia Business School, a wonderful value investment training ground. She brings a deep knowledge of global commodities from several years working at Trifigura, which will provide another new perspective to our investment team and process. Christina has lived in Europe, North America and Asia, and her enthusiasm for intellectual engagement and debate fits well with our investment team.

We are grateful for your continued trust and support, and as always, we welcome your questions and comments.

Warm Regards,

Team DWA

Note: All market data is from Bloomberg.

[1] For a more detailed discussion of inflation and its potential impact on investments, please click here to read our white paper, "Inflation: A Primer for Investors," published June 2021.

[2] Click here to read our white paper, "The Importance of Staying Invested," published May 2021.

[3] To read a more thorough one-page report on First Republic, please click here. DWA publishes these detailed briefs on every company in our model portfolio.

[4] To read the one-page report on JPMorgan Chase, please click here.