January 5, 2022

Dear Clients and Friends,

On the morning of April 9, 1867, following brief remarks by Massachusetts Senator Charles Sumner, the United States Senate ratified an agreement to purchase Alaska from Russia for $7.2 million in gold, less than $0.02/acre. In today's dollars, that equates to roughly $135 million, about what the federal government spends on interest payments servicing the national debt *every three hours*. Like all great investments, the Alaska purchase was controversial and poorly understood at the time. Criticized as "Seward's Folly" – for its architect, Secretary of State William H. Seward – the deal was seen by many as squandering scarce resources. Writing in the *New York Tribune*, Horace Greeley wrote, "Except for the Aleutian Islands… [Alaska] would not be worth taking as a gift." Seward himself expressed private doubts, believing it would take at least a generation for the intrinsic value of Alaska to be apparent.

He was about right: Alaska boomed in the years after the 1867 purchase, sparked by the Klondike gold rush in the 1890s and the discovery of vast quantities of oil decades later. The strategic importance of Alaska exceeded even its economic value, increasing the land area of the United States by 20% (663,300 square miles) and establishing our young nation as a continental and Pacific power – and an Arctic one too. Today Alaska generates annual economic output of roughly $50 billion, principally from energy, fishing and tourism, and its Permanent Fund, akin to an endowment for state residents, has more than $80 billion in investment assets. Estimating a market value for Alaska is imprecise at best but there is no doubt the 1867 purchase ranks among the greatest investments ever made.

The Wisdom of Seward's Folly

While none of us is likely to encounter an investment opportunity comparable to the Alaska purchase, the story highlights fundamental principles of value investing, including the huge advantage long term investors have over those compelled to trade securities in response to short term news. Seward understood what his critics did not: that time would unveil Alaska's true worth, which was likely to far exceed its prevailing market value as a remote outpost for fur traders. He didn't need to consult a spreadsheet to grasp that Alaska was a unique and irreplaceable asset with near limitless opportunity for patient investors. In terms our clients are familiar with, Seward understood the principles of economic moat, reinvestment opportunity and intrinsic value.

Discussion of Alaska and its abundant natural resources brings to mind **Canadian National Railway (NYSE: CNI)**, Canada's largest railway and a leading transporter of agricultural, mining and forestry products. Unlike trucking companies, air freight or ocean tankers, railways require capital to maintain and upgrade their track networks, but they can be exceptional businesses with durable cost advantages and formidable barriers to entry. In fact, the cost advantage of rail is now growing as supply chain failures and rising labor costs make shipping by rail more competitive over shorter distances. Although we have been CNI shareholders for years, controversy around the company's failed acquisition of Kansas City Southern recently gave us an opportunity to add to our position.

Among North American Class 1 rail operators, CNI is the gold standard. Start with its track system, the main source of an extraordinarily durable economic moat. CNI's network stretches west from the Atlantic coast to British Columbia, and south to the Gulf of Mexico, bypassing Chicago and thus removing a major north/south bottleneck. Additionally, CNI has exclusive rights to Port Rupert north of Vancouver, giving the company access to the largest ice-free harbor in North America. Moreover, the grade, or incline, of CNI's track is less than that for its competitors, translating into fuel efficiencies and lower operating costs. Replicating this track system is prohibitively expensive for an existing or future competitor.

The strength of CNI's economic moat is apparent in the company's financial performance. Operating margins are consistently the highest among its peers, averaging 50% in recent years, with net margins approaching 30% and returns on equity consistently over 20%. Since 2005 CNI has repurchased 33% of its common shares, grown earnings per share by more than

4x and raised its dividend from $0.21 to $1.87/share. The company has a fully funded pension plan and the lowest debt/cash flow ratio among Class 1 operators. After regulators effectively closed the window on large merger & acquisition opportunities, CNI announced a significant share repurchase program for 2022.

As the U.S. stock market barrels upward, driven in large part by trillions of passive investment dollars chasing mega cap growth stocks, our research effort remains focused on companies like Canadian National Railway, possessing the strategic and financial attributes to reward patient and thoughtful investors in the more volatile market conditions we envision.

Capital is plentiful and cheap

Equity markets have rewarded long-term investors for more than a decade, supported by abundant and cheap savings from years of accommodative monetary policy. Last year the S&P 500 returned 28.7% including dividends despite elevated inflation, a more hawkish Federal Reserve and yet another COVID variant. The stock market's performance has been impressive, but narrow: roughly 60% of the S&P's current constituents have underperformed the benchmark over the past two, three and five years. In fact, last year more than a third of the market's return was generated by just five stocks – Tesla, Nvidia, Microsoft, Apple and Alphabet. The Dow Jones Industrial Average, less technology-dependent than the S&P 500, returned just 18.7% last year. Investors' ardor for growth stocks has driven the market cap of the most popular stocks to stratospheric levels. Apple, for example, is now worth $3 trillion, more than the GDP of the United Kingdom, and its market cap exceeds the combined values of J.P. Morgan, Johnson & Johnson, Visa, Home Depot, Procter & Gamble, ExxonMobil and Disney despite having about 60% of the earnings power of those companies in aggregate. As ever more investors scoop up shares of Apple and its mega cap brethren via ETFs and index funds, the likelihood of mediocre future returns grows.

The biggest growth stocks are far from the only area of excess. Special Purpose Acquisition Companies (SPACs) raised more than $180 billion in initial public offerings in 2021 as investors looked past the absence of business plans and asymmetric economic models geared heavily in favor of management.[1] Meme stocks such as GameStop and AMC Entertainment soared and then crashed, whipsawed by speculators convening online to bet against hedge funds and institutional traders. The ARK Innovation ETF, described as a vehicle for investing in "disruptive innovation," fell -23.4% in 2021 after rising more than +150% in 2020 – and yet still trades at over 10x the revenue of its underlying portfolio companies, several of which have not yet achieved profitability. According to Bloomberg L.P., Bitcoin rose nearly 60% last year, paling by comparison to Ethereum (+399%) and other less widely owned crypto currencies. In March, 2021 a non-fungible token created by digital artist Mike "Beeple" Winkelmann sold for more than $69 million.[2]

A consequence of so much capital chasing appreciated assets is that essential products and services such as microprocessors and ocean tankers may suffer from underinvestment. No one can predict the financial markets' twists and turns, but we expect more balance in the months ahead, with investors looking beyond the largest growth stocks to find value among the laggards.

Growing economic and international risks for investors

As the stock market hits record highs, investors are focused on economic concerns: whether Omicron will stall growth, if inflation will accelerate and what impact the Fed's tighter monetary policy may have on stock prices. As explained in our Q3 letter, we believe these risks are manageable, with inflation likely to moderate this year as supply chains ease and the Fed withdraws excess liquidity at a measured pace. A more worrisome indicator is an unprecedented increase in household wealth. An analysis by economist Richard Duncan concludes that the ratio of household wealth to income is 19% above its previous high as we enter 2022, making economic growth unusually dependent on sustained high asset prices.[3] A sharp sell-off in financial markets could produce a recession requiring aggressive monetary and fiscal intervention.

In addition to these economic risks, investors are watching a handful of international crises that may affect markets. Under President Xi, China is cracking down on its most dynamic companies and challenging the post-WWII rules-based order in Asia, especially in Hong Kong and Taiwan, where the fate of Taiwan Semiconductor (TSMC), a globally significant company, hangs in the balance. As Graham Allison of Harvard's Kennedy School of Government wrote in 2015, in 12 of 16 historical examples

of a rising power confronting an established power, war ensued.[4] While risk of military conflict with China appears remote, in large part due to China's dependence on western consumers and business investment, it is a growing concern for investors. Turning to Russia, an invasion of Ukraine seems plausible, raising questions of how markets will adapt to potential conflict in Eastern Europe – and to Russia's longer-term decline, bristling as that country is with nuclear weapons and hobbled by corruption and a fragile economy. In our hemisphere, deforestation is once again surging in Brazil, home to 60% of the Amazon rainforest, which is now emitting more carbon than it absorbs.[5]

We are optimists, certain that human ingenuity and democratic capitalism will prevail. We believe, however, that the current investment environment presents elevated risks to investors, requiring expert financial advice. Quality common stocks remain the best defense against the market risks we readily perceive and those that are less obvious, and we are as confident as ever in the portfolios we manage for our clients. Our analysts are laser focused on identifying companies that serve large and growing markets from a commanding strategic position. Most of our portfolio companies have attributes similar to those of Canadian National Railway, including recurring revenue and pricing power with below average risk of technological obsolescence or competition from substitute products. They are run by shareholder-oriented managements with a proven history of smart capital allocation in terms of M&A, share repurchases and dividends. Companies added to the portfolio in the past year include **S&P Global**, **Autodesk** and **Sherwin-Williams** – all industry leaders with the financial strength to chart their destinies in a world of heightened risk.

An eventful 2021 for DWA

As with so many businesses, COVID was a stubborn presence in 2021, frustrating efforts to see clients and work together in person. We have kept our offices open throughout much of the pandemic ordeal. Most of our team was present from June through mid-December, although many of us are now back at our remote desks pending improved Omicron news. We are optimistic for a return to semi-normal in 2022, enabled by widespread vaccines and treatments and the hope of partial herd immunity.

Despite pandemic-imposed challenges, we are pleased to report another year of positive investment results for our clients and grateful that, with their support, we reached a milestone of $5.0 billion in assets under management. We added five terrific new employees last year and are thrilled to announce that Olivia Le Blan and Andrew Weinberg were admitted as partners.

A melancholy note for all of us at DWA was bidding farewell to our friend and partner, Grant Winthrop, who retired to his farm on the north shore of Massachusetts in October. We will miss his wisdom and sense of humor in the office, and the reminder that doing good work isn't enough: our values and fiduciary mindset are our highest callings. Thanks to Grant for a job well done and best wishes for chapters ahead, starting with his new role as chairman of American Farmland Trust.

To our clients, your December 2021 reports are enclosed. Sincere thanks to each of you for your confidence in our firm, and best wishes for a peaceful, healthy and prosperous new year.

Douglass Winthrop Advisors LLC

Please refer to footnotes and important disclosures on the following page.

Note: All market data is from Bloomberg, L.P.

[1] Bloomberg, L.P.
[2] https://www.theverge.com/2021/3/11/22325054/beeple-christies-nft-sale-cost-everydays-69-million
[3] Richard Duncan, "Risks are High and Rising, Macro Watch Fourth Quarter 20221" See www.richardduncaneconomics.com
[4] Graham Allison, *The Thucydides Trap: Are the U.S. and China Headed for War?*
[5] Luciana Gatti, et. al., "Amazonia as a carbon source linked to deforestation and climate change." *Nature*, July 15, 2021.