MEAD
CAPITAL MANAGEMENT

June 3, 2020

Dear Partners,

I like to begin communications with the word partner because it conveys my attitude toward managing your capital. The key attribute of a partnership, in my view, is a *shared* endeavor. Aside from the small advantage I have in earning a fee, and the slight differences in allocations across portfolios, we're in the same boat. Virtually all my family's investable assets are allocated in the same manner as clients. This creates alignment. Such an arrangement contrasts vividly to other investment managers who have huge conflicts of interest and sometimes nothing riding alongside their clients. (To be clear, I'm not talking about financial advisors, who perform a quite different and valuable service.)

I chose to begin with this reminder because the market has been volatile this year. You can be confident I'm making decisions for your portfolio that I'd make for my own because I am. The accounts owned by my wife and me collectively represent the largest client of Mead Capital. That means our fortunes (quite literally) rise and fall largely in lockstep, regardless of the percentage of your net worth represented by your Mead Capital accounts.

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Boarding the Same Train

Although all client partners are in the same boat that doesn't mean results track exactly. A better example might be that of a train. Some clients had the (in hindsight) bad luck to board toward the beginning of 2020 before the market declined precipitously. Those clients were able to take advantage of some good prices offered by Mr. Market but remain down for the year. By contrast, some clients opened accounts during the lowest points and took advantage of some very good (as it appears now) prices for businesses. Their accounts are up.

So, am I a terrible manager for "losing" money or a good one for "making" money? In both instances the answer is time will tell. It is *far* too early to make a judgement call. In time I expect the results of accounts managed by Mead Capital to converge to a point that represents my ability to evaluate businesses and purchase them at rational prices, and the underlying results of the companies we own. Because client accounts are roughly proportional (that is, invested pretty much the same), my advice to all clients at this point in time is the same: ignore the quoted market value of your accounts and focus on the businesses we own.

Enter the full train analogy. In many ways investing is like boarding a train. The train is setting off for a destination, and it's my job to make sure that destination is worthwhile. We're looking for a business (train) that has a lot of horsepower (good returns on capital) with a conductor (manager) that knows what he or she is doing. Once aboard the train and buckled in there's nothing one can do to change relative position. The result of the journey depends on the factors just described. Some clients gain a small advantage by boarding at a time that's favorable and might get to sit in the front carriage and therefore arrive at the station slightly sooner (i.e. earn a slightly higher return). Others board with relatively higher prices and might have to sit in the caboose. But here's the key point: aside from the differences in seating position all passengers' movements are dictated by the train itself. It's better to be at the back of a fast train than at the head of a laggard.

To exit the train analogy and be more direct, it is the performance of the underlying business that vastly determines results for an investor. Small differences arise due to one or a combination of entry price and exit price. These differences can seem larger in the short run but fade dramatically in the long term as business performance dominates the equation. Here's a hypothetical example:

1. Betty Badluck finds a good business earning a 15% return on capital. She pays a valuation that represents 150% of the underlying capital in the business, so her going-in return is 10% (15% / 1.5). Shortly after buying her stake in the business the stock price declines by 33% and then rebounds by 25%.

2. Lucky Larry has the fortuitous timing to buy the same company as Betty right at the bottom when it's on sale. He pays a price equal to the amount of capital invested in the business. Larry's going-in return is 15%.

We can pause right here and make some observations. Betty, if she is like most investors, will bemoan her bad timing. Her investment is down 16% (33% decline followed by a 25% increase). Larry on the other hand feels like a genius; his investment is up 25%. Both, however, own the same underlying business. To go back to our train example, Betty is riding on the caboose while Larry caught the front seat in the front car. Who will do better over time? That depends on time. If both sell their investments immediately Betty will lock in a loss and Larry will lock in a gain. But suppose both act as business owners and hold on for ten years? Further suppose over that time the market revalues the company to multiple of 1.25 times its capital.

For simplicity sake I'll assume the business pays no dividends and can reinvest at the same 15% internal rate of return (real world business results are never so linear). After ten years the results of our investor-passengers look like this:

1. Betty: Her total return is about 13%. Taking things apart we can see that it resulted from the 15% return of the underlying business less about 2% a year attributable to the multiple contraction (she paid 1.5 times the company's underlying capital, the market revalued the company to 1.25 times).

2. Larry: His total return is about 17.5%. The same 15% came from the underlying business while the remainder came from his multiple expanding from 1.00 times to 1.25 times.

The longer an investor holds an investment the more the underlying return of the business comes to dominate the eventual return. Betty's return will slowly increase to 15% the longer she holds, and Larry's will by contrast slowly decrease to 15% the longer he holds (assuming the rate of return of the company remains the same 15%). The underlying cash flows remain identical to each investor, it is only the return that changes depending on price.

One final thought before I move into a discussion of our holdings. Both Betty and Larry should have hoped for a stock price that languished over their holding periods. Why? They could have made additional purchases to increase their ownership stake at attractive returns. Or, if a good manager and board were at the helm, the company might have used some of its cash flow to repurchase shares at attractive prices. Regardless of the valuation paid for their initial stakes *both* would improve their total returns under that scenario. High stock prices only make investors *feel* richer; their real wealth stems from the assets they own through the companies they invest in.

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The hypothetical example above is analogous to the situation across Mead Capital clients. We own some great businesses, but the prices paid for those businesses vary widely in some cases. That's okay. What matters most is that each purchase is made with a reasonable expectation of satisfactory long term returns. I may be wrong in judging either the quality of the business or the appropriate valuation. But every purchase is made based on business fundamentals. We look to the underlying business to guide decision making and judge results, and *never* count on multiple expansion. It's great if it occurs, of course, but to seek multiple expansion is betting what others will do and is clearly within speculation territory.

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Berkshire Hathaway

Berkshire remains our largest holding by far, representing 40-50% of most portfolios. Berkshire is not one giant business but a collection of businesses large and small. Ignoring factors that give Berkshire important sum-is-larger-than-the-parts advantages, it's a diversified conglomerate that operates across wide swaths of the American economy. For a more in-depth view at Berkshire, including my thoughts on valuing it, please see the 2019 Annual Letter; I'd be happy to send any existing or prospective client a copy, just ask.

The majority of Berkshire's earning power resides in the BNSF railroad, its huge and varied utility businesses, and its many diversified insurance businesses. These are economically resilient businesses that should do fine during any recession or even a depression. The remainder of Berkshire's businesses cross the economic spectrum. Some will do okay, some will surely suffer as a result of the shutdowns and any prolonged pandemic, and still others might thrive. Those that make it through the maelstrom will likely come out stronger. Many of Berkshire's businesses continued to build their competitive positions during periods of economic weakness in the past, and I'd expect this to continue going forward. That doesn't mean that business results won't suffer; in fact, it's likely in the short term.

Berkshire's balance sheet is probably the strongest in the corporate world. At the end of the first quarter Berkshire had over $130 billion in cash, over $200 billion in marketable securities, and very little debt (the debt it has is structured long-term and most is non-recourse to the parent company). It has the financial firepower to take advantage of market disruptions, and I'd expect it to serve as a supplier of credit if/when the Fed steps back from that role.

I have to admit I was slightly disappointed by Berkshire's lack of repurchases during the first quarter. It repurchased just $1.6 billion, or 4,900 A-equivalent shares, which represented about one-third of one percent of the company. Why didn't Berkshire step up repurchases, or make more investments in marketable securities when prices were lower? Reading between the lines of the webcast annual meeting, Buffett remained optimistic on America long-term while acutely attuned to the near-term risks. I believe Buffett viewed the economic situation as extremely perilous (which it was and is) and buttoned down the hatches. This didn't mean selling businesses or stocks which Berkshire owned, but rather a halt to going all-in. As bad as things got earlier this year we've not come close to the point of maximum pessimism.

Watching Buffett's commentary and Q&A during the four hours of the meeting I came to realize I had been far less pessimistic than I should have. A pandemic is far different than anything anyone has ever seen and the economic implications are almost unknowable. There exists a non-trivial possibility that events align in such a way that create a downward spiral which results in a true depression-like scenario. It's still a small probability (and again, no reason to go to cash), but Buffett is acting in the best long-term interests of shareholders and policyholders, and I can't fault him for not jumping in with two feet. Businesses that were leveraged and on the brink of failure were given a pass by the Federal Reserve. And even that might not do the trick. More than likely we will see a significant recession that affords Berkshire the ability to put more cash to work and in an environment that gives Buffett the clarity and confidence to repurchase lots of Berkshire stock.

Berkshire's valuation remains attractive. It is one of the best risk/reward investments I can find for us. It will very likely remain a cornerstone of our portfolios for the indefinite future. On a look-through basis, which is how I view all of our investments but is especially important with Berkshire, it holds cash equal to about 30% of its market cap. Multiply this by the average of 40-55% of Berkshire across client accounts and it means clients hold 12% to 17% cash through their ownership of Berkshire. It's one reason why I'm more comfortable holding less direct cash at this point in the cycle.

Copart

Copart was only moderately impacted by the recent shutdowns and benefitted (relatively speaking) from being classified as an essential business. It was classified as an essential business because of its job clearing unusable cars from a disposal network that isn't setup to hold much inventory. Without Copart's services tow yards would quickly fill up and cars would remain on the streets. Its business will take a hit as fewer accidents translates into lower volume, but it's inventory and global network will continue to operate. Critically, Copart's online auctions mean it does not need to have large volumes of bidders congregate in one place, an obvious concern for health authorities during the pandemic.

The strength of the Copart management team shone through in its recent investor call. The company is focused on the long-term benefit it can provide to customers and continues to make long-term investments in storage yards and infrastructure that will be of use long after this pandemic or other disruption passes. Its relatively-new business in Germany continues to do well. With operations now in place in Germany, the company has turned to proving its business model to the somewhat entrenched European insurers. The company is confident its value proposition will ultimately prevail.

Hingham Institution for Savings

The process of owning businesses is an active one, even if such activity doesn't translate into trading. That was the case with Hingham this quarter. During the webcast annual meeting (at which I also was able to ask a couple questions of management) I learned more about the bank and became even more comfortable with it as a long-term investment. I now have a deeper appreciation for the Hingham management team as risk managers. They truly understand what they do and seek to eliminate everything else. The bank shuns almost all activities except basic deposit banking and real estate lending. Here's a slide from their annual meeting presentation showing what they *don't* do:

Hingham is such a great example of the notion that simple doesn't equate to boring or low return. Just the opposite. Focusing on its simple business, Hingham has generated consistent returns on equity of 15% while maintaining about a reasonable 10% leverage ratio. This comes about through the simple formula of low overhead and low loss ratios. The management team disclosed during the annual meeting that its average loan-to-value ratio of its portfolio was in the mid 50% range. That is a striking statistic; most banks regularly operate in the 75% range and many (because of competitive pressures) go to 80% or sometime higher in their commercial books.

The bank also vests *all* its loan authority in its executive committee. This is again quite different from most banks that give most management teams some individual authority. In placing the loan authority with its board the bank ensures it owners (the executive committee members collectively own one-third of the bank) know exactly what's in the loan book. Hingham's judicious risk management, enhanced by the fact that management owns one-third of the bank, serve as meaningful mitigants to any storm currently on the horizon.

Synchrony Financial

The best way to describe Synchrony at present is a prize horse that's injured its foot and caused the odds of its winning the race to fall far out of line with what it previously commanded. Said another way, Synchrony's business is sure to suffer from defaults and losses stemming from consumer weakness. But its stock price has declined to such a degree that the odds now given by the market more than offset the potential for underlying business deterioration. I very well could be wrong. Synchrony is heavily tied to the health of the consumer, an integral component of our national economy.

However, at the moment the key pieces of information leading me to view the company as a satisfactory holding are: a) its focus on higher-quality credits; b) its loan loss reserves of about 11% of its portfolio; c) its strong capital ratio; d) its low overhead ratio. These factors, coupled with a price that currently values the company at book value and a low ratio of earnings power put the odds in our favor. And although the company has since suspended its share repurchase program, management repurchased 5% of the company during the first quarter.

Cimpress

The management team at Cimpress, which includes its founder, reacted swiftly to the pandemic. They quickly moved to right-size the business to what they perceived as the new normal of business. Fortunately, the company has a cost structure that's heavily-weighted toward directly variable or easily-variable costs. It's hard to determine the exact impact of the pandemic and a recession on Cimpress. It will undoubtedly see a decline in revenues and profits due to shutdowns, and may experience lingering effects afterward and into a recession. But it's a low-cost operation compared to its peers, which will make it shine when small businesses begin to advertise and market with more budget-consciousness. Through the first three quarters of its fiscal year Cimpress repurchased five million shares or about 17% of the company. It won't be able to repurchase shares under its modified credit agreement, however. That move gave the company significant financial flexibility in exchange for certain concessions that included forgoing share repurchases. Given the uncertainties that remain for Cimpress I view this as prudent.

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I'm constantly reminded how uncertain the future is and always will be. The best we can do is evaluate all the facts in front of us at any time and make the most rational, probabilistically-weighted decisions possible. The current economic landscape and the strength with which markets have rebounded from their lows gives me great pause. The facts at present (in short, a market that appears to be greatly discounting a drastically altered economic landscape) lead me to believe caution is warranted. I am in no way attempting to predict the future and continue to shy away from macroeconomic forecasting. My focus remains on a bottom up approach to finding and buying businesses regardless of what the market does in the short term. If a good business is available at a rational price, we'll buy it no matter what the market is currently doing or where we appear to be in any particular cycle.

The market fluctuations at the beginning of this year should fortify you for what may come again this year—and will surely come again at some point. In short, I think it could get very bumpy. But therein lies our opportunity to buy good businesses for the long term.

Once again, I'm comfortable with the businesses we own for the long-term, especially considering the attractive valuations of most of our holdings. Owning businesses through the stock market requires part financial acumen and a psychological makeup that allows fortitude in the depths of apparent crisis. We will have future crises again, that is certain. When is anyone's guess. We'll be ready.

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In writing this letter I hoped to communicate my thoughts on and comfort level with our major investments. I've gone a little deeper into each company than I would under normal circumstances. Some excellent questions from one client-partner was the catalyst I needed to get going, and I thank him for the suggestion.

Fortunately, the strategy we employ in searching for and owning great businesses is one of continual but not rapid change. The annual letter will remain the main mode of communication each year, which is appropriate for the long-term ownership strategy we follow. That means absent a major event (like a pandemic) or a significant change to our investments or my thinking, written communications of this length won't become a regular occurrence.

All of that said, I do welcome and treasure the conversations I have with you, my client-partners. Without a doubt I am a better investor for having such well-informed and long-term thinking clients. Please feel free to call, text, email (or even Zoom!). Until/unless Mead Capital grows to such a size that prevents me from discussing our current or prospective holdings for legal or competitive purposes, all topics are fair game. (Whether I'll be knowledgeable on said topics is another question.)

I wish you all a safe and enjoyable summer.

Warmly,

Adam

Important Disclosures:

Mead Capital Management, LLC is a registered investment adviser based in Derry, New Hampshire. Adam J. Mead is its principal, CEO, Chief Investment Officer, and managing member.

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