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2014 Mid-Year Investment Perspectives

Summary

Following a relative pause in the market during the first quarter of the year, which included a significant drawdown and then recovery, the market resumed its generally strong upward course during the second quarter of 2014. Widening the lens a bit, the second quarter appeared to be a continuation of the trend that has persisted for several years now:

- *Companies on average have delivered modest underlying earnings growth but the market has been amplified by price-to-earnings multiple expansion*
- *Faster growing companies, the one's we own, have been rewarded less than slower growing companies in the last three years. EPS growth 2011-2013 Polen 17% vs. S&P 500 9%*
- *Leveraged companies are still seeing the most favor in the persistently low long-term interest rate environment, the companies we own - High Quality Growth- have been out of favor by the market*

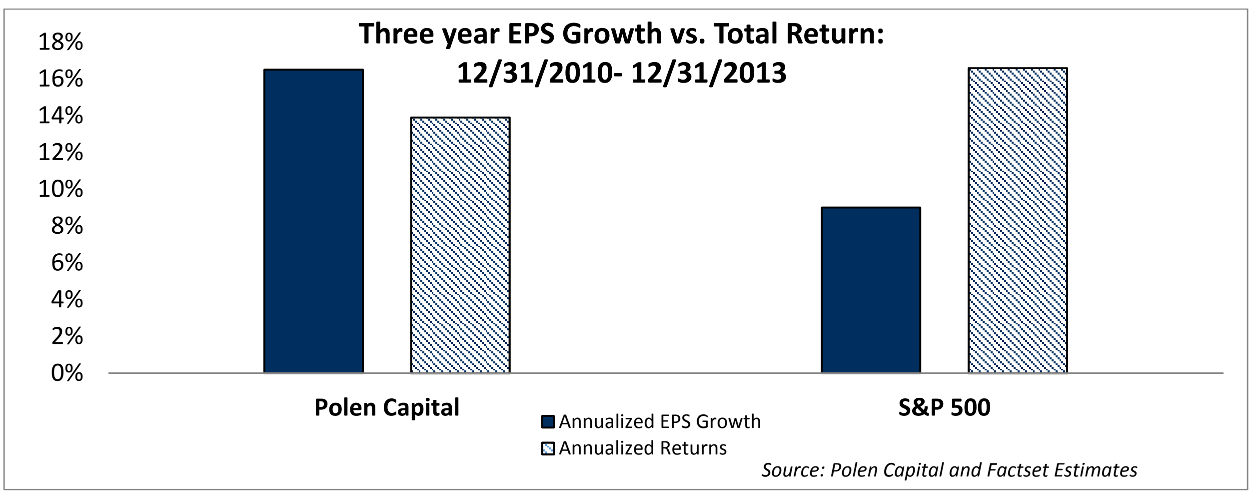
After a powerful five-year stock market rally since the credit crisis of 2008 and massive multiple expansion, over the past three years in particular, that has helped inflate stocks of all types, we believe fundamentals will become more important drivers of future returns. We are particularly pleased with the strength of the businesses we own and are confident that their strong fundamentals will produce superior risk adjusted returns over time. Over our 25-year history, we have experienced several challenging market environments like the one we face today. We have always remained true to our investment discipline-focus of owning high quality businesses with sustainable competitive advantages. This commitment has served us well over time and we are confident it will do so in the future.

Investment Perspectives

Exploring our performance as well as the market indices during this strong stock market rally provides some interesting perspectives. As of 6/30/2014, the Polen Strategy generated healthy absolute annualized returns of 13.9% and 17.9% over the past 3 and 5 years, respectively, which is consistent with our expectations. Furthermore, these results were produced with less volatility than the majority of our peers. However, on a relative return basis, we trailed the major market indices: the Russell 1000G Index returned 16.3% and 19.2% over the past 3 and 5 years, respectively. (The S&P 500 Index had similar results). Since the bulk of our Strategy's underperformance has occurred during the past three years, we are going to focus our attention here. The Strategy's 3 year return of 13.9% is in line with our 25-year since inception annualized return of 14.3% (as of 1/1/1989). However, the markets returns (R1000G 16.3% and S&P 500 16.6%) over this period are far above their roughly 10.0% annualized return since 1989. These numbers should provoke at least two questions: (1) why have the returns for the indices over the past 3 years been significantly higher than their long-term averages? And 2) why has the Polen Strategy trailed the indices over this period?

To answer the first question, we must look at the performance measurement period we are using, which has been an economic recovery. During periods of economic expansion, corporate earnings growth tends to be faster than average, and this has indeed been the case. From the end of 2010 to the end of 2013 we calculate that the growth in weighted average earnings per share for the S&P 500 has been 8.6%. This compares to a 25-year historical estimate of 6% for the S&P 500. It is also true that price/earnings (P/E) multiples were depressed after the GFC five years ago and have now risen to more "normal" levels.

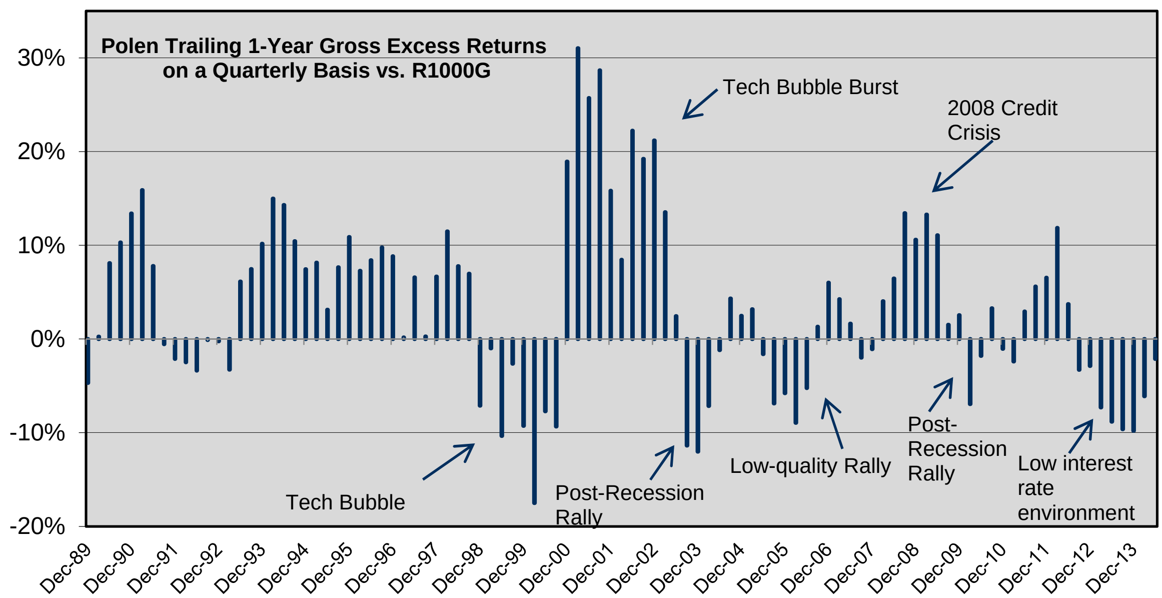
The second question is a bit tougher to answer. Our Strategy has also seen strong earnings growth since 2010. For the past 3 years we calculate the growth in weighted average earnings per share of our Strategy to be 16.5%, which is stronger than our long-term 25-year average of 12% and also at a larger than normal differential to the indices. However, the Strategy has underperformed the indices by approximately 230 basis points annually over the past 3 years. We have been on record for many years saying that earnings growth (and to a lesser extent dividends) drive investment returns over long periods of time. But since our Strategy has experienced significantly faster earnings growth (with slightly lower dividends) than the indices over this period, shouldn't the Strategy have outperformed the indices? We believe it should unless there is meaningful contraction in the P/E multiple of our portfolio, expansion of the indices' P/E multiple, or a combination of both. Indeed, we have seen a combination of slight contraction in the P/E multiple of our Strategy, while the S&P 500 has seen substantial multiple expansion. Reference the chart below.



So why has the S&P 500 seen nearly 17% annualized appreciation with less than 9% earnings growth? Although we typically avoid pontificating on macroeconomic issues, we feel that it merits some discussion. As our long-term clients know, it is not uncommon for our portfolio to underperform substantially in strong up markets where stock appreciation outpaces the fundamental growth of the underlying companies. In our 25-year history, this has happened on five separate occasions. (Reference the chart on the following page). It happened in the late 1990s (tech bubble), in 2003 (post-recession rally), in 2006 (low-quality rally in commodities and levered financial companies), in the middle of 2009 (post-recession rally) and now again in calendar year 2013. In each of these periods, our portfolio underperformed the market by approximately 10 percentage points. But at some point, valuation and fundamentals ended up winning out, and we see no reason why this shouldn't continue going forward.

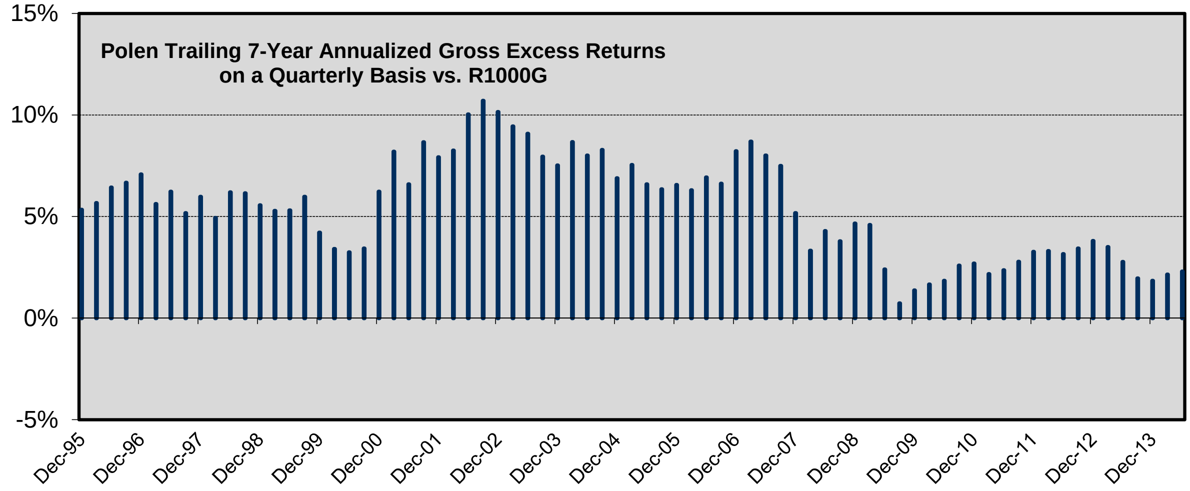
Counterbalancing our relative underperformance in strong "up" markets has been our substantial outperformance during big market drawdowns (2000-2002 tech bubble burst and 2008 credit crisis). In each of these periods, we outperformed by at least 10 percentage points. It should come as little surprise that historically the movements of "the market" are substantially greater than the movements of our portfolio. That is to say, the volatility or standard deviation of our portfolio has been substantially lower than the indices. This is because our portfolio includes only companies with pristine balance sheets and large, durable competitive advantages. Companies with these characteristics tend to go down less in bear markets. But in market environments that are more speculative in nature, the high quality companies we own also tend to trail the market.

In the Short-term Mr. Market Tends to be a Voting Machine



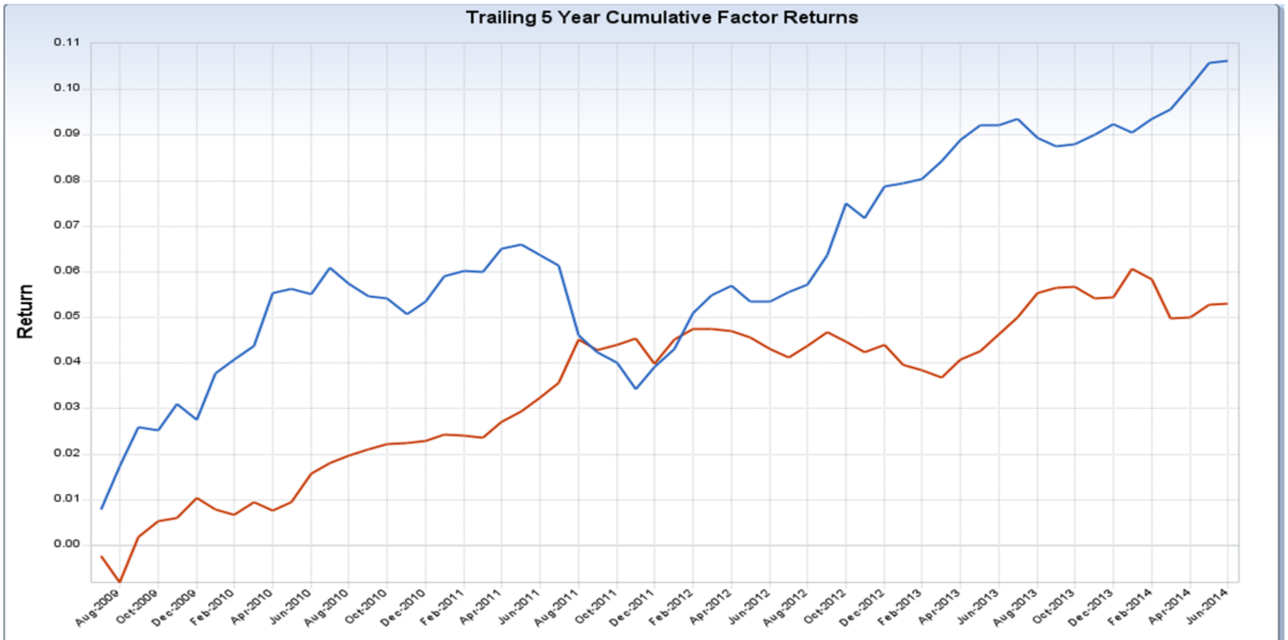
- There have been 99 trailing one-year periods since our inception in 1989 and we have only outperformed during 61 of them (or about 63% of the time).
- There have been five occasions in our 25-year history of where the Strategy underperformed the R1000G Index by a significant amount, including today.
- However, we have delivered strong absolute and relative performance over time and especially in down markets like the bursting of the tech bubble and the GFC when our clients need it most.

Over Time Mr. Market is a Weighing Machine Driven by Fundamentals



- As a result of our focus on high qulity businesses with sustainable competititve advanatages , we have outperformed in all rolling periods of 7 or more years over our 25-year history, which includes one or more market downturn.
- We have produced one of the strongest long-term track records in the business (and with greater consistency than the vast majority of our peers), while trailing the index by a healthy margin during several shorter periods of time along the way.

Since the credit crisis, central banks across the globe have conducted large scale quantitative easing programs to keep interest rates very low in the hopes of pushing funds into riskier assets, thereby causing some asset inflation. To a large extent this has worked, as financial and real assets across the risk spectrum have inflated profoundly since 2008. This type of environment is most favorable to the least common denominator. Just as you would expect the most profligate spenders to benefit the most if their credit card interest rates suddenly dropped to 0%, the same can be true for businesses. Many of the most highly levered and acquisitive companies have been able to borrow far more money at far lower interest rates than they would have been able to at any other point. This has led to a windfall of profits to these companies as they refinance their existing debt at extraordinary low rates and can make most acquisitions accretive to earnings when borrowing costs are as close to zero as they have ever been. The companies that grow organically and maintain rock-solid balance sheets receive no such tailwind and, as a consequence, their stocks have lagged. Reference charts on the following page.



Source: Barra Portfolio Analytics

- Highly levered companies (blue line) have enjoyed a tailwind over the past 5 years from the aggressive quantitative easing programs.
- The exception being 2011, a year in which our strategy outperformed given our focus on high quality, less leveraged businesses.
- While faster growing companies (red line), which Polen favors, have been rewarded less especially over the past 3 years.

Source: S&P

- S&P 500 companies have gotten a $300 billion tailwind from lower rates over the past few years. This benefit has accrued most to the highly levered and arguably lower quality businesses.

A natural reaction would be to tack into the wind and invest in companies that benefit from the prevailing trends of ultra-low interest rates and acquisition roll ups. You won't be surprised to hear that we will not do that. We are students of history, including Polen Capital's own history, and if there is one thing that we know above all else, it is to avoid taking undue risk at all costs. Taking on significant amounts of financial leverage is one of the surest ways to jeopardize the viability of an enterprise that we are aware of (especially if combined with a business that lacks a competitive advantage). This doesn't mean that we will not invest in companies that have manageable amounts of debt, but it does mean that we will not invest in companies that have too much financial leverage. We believe that time is on our side, and by investing in consistent growth companies that continue to grow their earnings not just for years, but often decades, we can continue to protect and grow our clients' capital through both good times and bad. The further assets inflate, the more cautious the prudent investor should become. We have a very long time horizon and are very content with our current portfolio and how it is positioned for the long term.

Looking back over the past three and five years, we are particularly pleased with the strength of the businesses we own. It is most important to follow the health of the underlying businesses. If the company remains a vibrant growth business with large, sustainable competitive advantages, we firmly believe its share price will appreciate meaningfully over time. While we certainly have made mistakes, the Strategy is based on the same core principles that have guided Polen Capital's outperformance over its long history – namely a concentrated portfolio of financially superior, competitively advantaged companies that can grow earnings at satisfactory rates over long periods of time. There is a balance of fast growing companies that are seizing on new market opportunities and more modest growers that dominate large and established markets. The balance of these types of growth companies is what has allowed our firm to achieve strong downside protection over the years but still participate nicely in up markets. Our team is disciplined and intellectually curious – a perfect combination to take us forward from here.