First Quarter 2021 Market Review and Outlook
Taking Advantage of Drawdowns

There were a couple significant market events that contributed to the first quarter's choppiness. First was the enthusiasm for popular social media driven short squeezes, like GameStop, that led to an unwinding of positions and sharp risk-off behavior at the end of January. Second was the unraveling of institutional and, moreover, retail enthusiasm over speculative tech and sky-high valuations as fears of oncoming inflation led to a rise in interest rates, even despite the Fed's continued stance of "lower for longer."

Outside of the GameStop's (ongoing) rollercoaster, investor fervor and rich multiples led to a flood of private companies going public via special purpose acquisition companies (SPACs). While there are certain advantages to SPACs like speed to market, there are also disadvantages to investors such as a lack of transparency, financial scrutiny, and potentially misaligned incentives. Despite the media's enthusiasm for these stocks, we have generally avoided these speculative areas of the market given little diligence, potentially untested business models, and the market's recent history of bidding up SPACs based on rumors. We would note that Clarivate (CLVT), one of our top performers last year, became public via SPAC; however, in the case of Clarivate, the merger had been completed and it was for a durable and highly recurring business model led by a proven CEO.

Later in the quarter, equity markets were rattled as strong U.S. economic activity and oncoming fiscal spending raised concerns of rising inflation that triggered a move in interest rates. The 10-year U.S. Treasury yield increased from roughly 1.0% at the end of January to a high of 1.74% at the end of the quarter. Led by high multiple tech stocks, rising interest rates sparked a broad market selloff that saw the Nasdaq Index decline ~12% from February 12th to March 8th and the S&P 500 decline ~6% from February 6th to March 4th.

Our investment team is mindful that an even steeper rise in inflation expectations and interest rates can further damage equity valuations, but we agree with Federal Reserve Chairman Jerome Powell that an increase in inflation will likely be transitory. Moreover, we believe the U.S. economy will need some time to absorb the over 10 million people who are still unemployed or under-employed. As such, we do not believe that the Federal Reserve will raise interest rates until we have full employment and that the Federal Reserves will let inflation run above average for a while. While interest rates could continue to move upwards ahead of Fed policy, we observe that the S&P 500 has had a strong track record during periods of rising interest rates, especially when supported by strong economic growth.

S&P500 Returns During Periods of Rising Interest Rates

Start Date	End Date	Duration	10-year Yield Start	10-year Yield End	Change in 10-yr Treasury Yield	S&P 500 Price Return
12/26/1962	8/29/1966	44M 3D	3.8%	5.5%	1.7%	18%
3/16/1967	12/29/1969	33M 13D	4.5%	8.1%	3.6%	1%
3/23/1971	9/16/1975	53M 24D	5.4%	8.6%	3.2%	(18)%
12/30/1976	9/30/1981	57M 0D	6.8%	15.8%	9.0%	9%
5/4/1983	5/30/1984	12M 26D	10.1%	14.0%	3.8%	(8)%
8/29/1986	10/16/1987	13M 17D	6.9%	10.1%	3.2%	12%
10/15/1993	11/7/1994	12M 23D	5.2%	8.0%	2.9%	(1)%
1/19/1996	7/8/1996	5M 19D	5.5%	7.1%	1.5%	7%
10/5/1998	1/21/2000	15M 16D	4.2%	6.8%	2.6%	46%
6/13/2003	6/28/2006	36M 15D	3.1%	5.2%	2.1%	26%
12/30/2008	4/5/2010	15M 6D	2.1%	4.0%	1.9%	33%
7/24/2012	12/31/2013	17M 7D	1.4%	3.0%	1.6%	38%
7/8/2016	10/5/2018	26M 27D	1.4%	3.2%	1.9%	35%
3/9/2020	2/25/2021	11M 16D	0.5%	1.5%	1.0%	39%
8/4/2020	3/31/2021*	7M 27D	0.5%	1.7%	1.2%	20%
				Average	2.9%	17%
				Median	2.4%	15%
				Periods Positive Return		11
* Ongoing. Excluded from Average, Median, & Period Figures				Periods Negative Return		3

Source: Bloomberg

With this view in mind, we attempted to take advantage of the intra-quarter market selloffs to invest in several high-quality companies that have been on our “wish list”. We believe each of these companies has a strong moat and are improving their competitive positions and services to their customers.

During the meme stock driven drawdown, Disney (DIS) sold off over 12%. We have owned Disney in the past and have admired how well Disney has pivoted its business to address the secular shift from traditional distribution (cable and satellite partners) to on-demand and streaming, specifically by distributing its best-in-class content through Disney+, its own direct-to-consumer streaming platform. As of March, Disney+ has captured over 100 million digital subscribers within just 16 months of launch. We believe Disney’s scale and unmatched catalogue of intellectual property will allow it to be one of the long-term winners in the direct-to-consumer streaming market. Moreover, our analysis suggests that in a few years, Disney+’s growth in revenue should outpace its growth in content spend as the platform reaches scale. In other words, Disney is poised to see margin expansion from its streaming services.

In the meantime, Disney is also a re-opening beneficiary given the tremendous amount of pent-up demand for leisure travel and entertainment following a year plus of sheltering in place. Disney’s theme parks, hotels, cruise ships, and theatrical revenues should all benefit from a likely strong surge in consumer spending on experiences. Given the company’s pricing power, Disney should continue to be successful in raising prices to offset inflationary pressures.

Another wish list opportunity we added was Amazon (AMZN). Jeff Bezos wrote in Amazon’s 2016 annual letter that for Amazon, “Day 2 is stasis. Followed by irrelevance. Followed by excruciating, painful decline. Followed by death. And that is why it is always Day 1.” Bezos’ words speak to the culture at Amazon of never resting on their laurels. Perhaps there is no better example of this philosophy than by watching how this company repeated turns its biggest costs into leading and profitable businesses. Amazon’s core business is its eCommerce platform which generates close to $500 billion of gross merchandise value each year. Rather than resting on this remarkable achievement, Amazon continues

to expand its addressable market. For instance, Amazon's scale and investments in logistics enable the company to offer third-party seller services. Amazon will help list merchandise, warehouse, fulfill product, and handle customer service and returns for third-party merchants. This complete seller solution is more efficient and less expensive than if the seller performed each function themselves. With third-party seller services, Amazon expanded its addressable market and leveraged otherwise internal costs to earn an estimated 20-40% fee on merchandise value. Amazon's third-party seller services generates a higher profit margin and is also growing faster than Amazon's original first-party eCommerce business.

Another example of Amazon turning a cost center into a high-quality business is Amazon Web Services, or AWS. Here, Amazon leverages its technology investments by renting space on its servers and lending computing power to other businesses. AWS literally created cloud computing-as-a-service. It's no surprise that AWS leads this market with over $45 billion revenues and growth of over 30% a year. AWS today generates 30% segment profit margins and accounts for over 60% of Amazon's profits.

Amazon continues to expand into other businesses, including advertising, healthcare services (again leveraging a high internal cost center), and subscription services (Prime, Audible, music, etc.). Amazon is already quickly growing its advertising business within its marketplace ecosystem, enabling merchants with the ability to attract new customers. In 3 years, we believe this advertising business has the potential to become the size of AWS today, if not larger, while also operating at a higher margin and lower capital intensity than AWS. In media, Amazon will now broadcast the NFL's Thursday Night Football games, adding content to its library of shows, movies, and music, all of which strengthen the value proposition of its Prime membership. We view Amazon as having a durable competitive moat that is only getting stronger. As Amazon underperformed more speculative areas of the market, it provided us an attractive entry point to own a company that should continue to grow at an attractive rate for many years.

2020 was a year that accelerated digital transformation. One of the foundational technologies enabling next generation data centers, 5G networks, autonomous driving, artificial intelligence, gaming, and digital currencies is the semiconductor. Nvidia (NVDA) is the leader in graphics processing units, or GPUs, with its chips having dominant market share in several growing industries. Whereas CPUs can handle most general-purpose workloads and are optimized for sequential serial processing, GPUs enable parallel workloads that allow for processing of larger data sets in less time while also consuming less power. Traditionally, GPUs were used for rendering 2D and 3D graphics and images, but they are increasingly being used for computationally intensive tasks needed for machine learning and artificial intelligence along with next-generation data centers that are needed to process big data.

Specifically, in PC gaming, Nvidia has a dominant market share (over 70%) where it has a base of 200 million installed PC gamers using its GPUs. Outside of PC gaming, Nvidia also provides GeForce Now for cloud-based gaming, systems-on-a-chip (SoCs) for Nintendo Switch, Shield devices for gaming and streaming, Broadcast for live streaming, and Virtual Reality development platforms. Nvidia's GPUs are also taking share in the increasingly important data center accelerator market where the company's GPUs power 70% of the top 500 supercomputers (and 8 out of the top 10). Every major cloud provider,

including AWS, Azure, Oracle, Alibaba, and Google, uses Nvidia's GPU chips. Finally, Nvidia's GPUs are also enabling work in AI where modeling complexity is doubling every two months.

While Nvidia's parallel processing architecture is a step function improvement over sequential processing for large datasets, Nvidia has further differentiated its competitive advantage by building software stacks to complement its GPU chips. In fact, over half of Nvidia's engineers are software engineers. The company's software platform, CUDA, has attracted over 2.3 million developers who in turn have supported over 6,500 startup companies. As such, Nvidia's moat of a superior architecture is further strengthened by its software stack. We believe Nvidia's technological foundation will enable the company to grow at a high rate enabled by multiple industry tailwinds for many years. We were excited to add Nvidia to our portfolios after it declined about 20% in March. We believe this will mark an attractive entry point for this secular and cyclical growth company.

Finding Space in the Portfolio

It's becoming increasingly more difficult to find space in our portfolio. However, to fund these new ideas, we had to make room. During the quarter, we sold The New York Times (NYT), Clarivate (CLVT, formerly CCC), Starbucks (SBUX), and Visa (V). While these companies continue to be wonderful businesses with exceptional management teams, we believe their growth prospects were fully reflected in their valuations and our new additions had more attractive upside.

Looking Forward

We see many opportunities and challenges in 2021. For instance, there are still over 10 million people unemployed or underemployed. However, as the rollout of several effective vaccines continues, we expect to see a big spike in consumer and business activity, and thus an environment that should provide more job openings. A steeper yield curve unsettled the market in recent weeks and will increase borrowing costs for individuals and businesses, but it is also a positive signal of economic expansion. With further stimulus packages planned in the U.S. and abroad, we believe that the U.S. is well positioned for a strong economic recovery. It has been our experience that, over time, stock price appreciation directly correlates with earnings growth. With a strong economic backdrop, we believe our portfolio of high-quality growth stocks trading at reasonable valuations is well positioned to compound earnings and returns for the years to come.

We have made significant strides since our management-led buyout in 2017 and are proud to introduce our new firm name this quarter. As TCM – TRAN CAPITAL MANAGEMENT, we look to continue to build a lasting partnership with you, all while seeking to generate outstanding investment returns. Thank you for your partnership and we look forward to our next correspondence. If you have any questions, please contact us at (415) 461-3800.

Sincerely,
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