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Introduction to FourThought Consistent Growers

FourThought Consistent Growers aims to deliver long-term growth and capital appreciation by investing in companies with proven track records of consistently growing free cash flow over time. Our investment process is based on identifying high-quality companies with unique value propositions, competitive advantages, and strong financial positions.

Portfolio returns are generated through the compounding earnings growth of competitively advantaged companies owned for many years. Our belief is that over long periods of time, share prices tend to follow earnings growth.

In FourThought Consistent Growers, we use guardrails of strong balance sheets, abundant free cash flow, strong Return on Equity (ROE > 20%), and real organic revenue growth in our stock selection process. This paper serves to delve deeper into the underlying investment philosophy and research processes that encompass growth investing at FourThought.

Investment Philosophy

Our investment philosophy for FourThought Consistent Growers was molded over time as the accumulation of various investment literature and time-tested truths that apply to investing in growth stocks. Perhaps no one author has had a greater impact on our investment philosophy than Jim Collins in his works “Good to Great” and “Great by Choice.” In these books, Collins and his team analyzed thousands of companies to find similarities between those that went from ‘Good’ to ‘Great’ in terms of business performance, which also made for great investments. Collins, through his research, highlighted a few principles that we use in our investment research process for the Consistent Growers Portfolio – the “20-Mile March” and the “Flywheel” concept.

20-Mile-March

In “Great by Choice,” Collins introduces the idea of the “20-Mile March” as a metaphor for consistent progress and performance. The concept is derived from the practice of early Antarctic explorers (led by Roald Amundsen), who set a daily goal of covering a fixed distance regardless of favorable or adverse conditions. This disciplined approach allowed them to maintain a consistent pace and increase their chances of success.

Source: The race to the South Pole: Scott and Amundsen | Royal Museums Greenwich (rmg.co.uk)

Collins’ research suggests that great companies prioritize sustainable growth instead of chasing short-term gains. Similarly, our Consistent Growers portfolio focuses on investing in companies with sustainable business models, strong competitive advantages, and the potential for long-term growth.

In short, we look for companies that can maintain their competitive edge and continue to grow steadily over time.

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High-Quality Compounding – The Flywheel

Jim Collins' "Flywheel" concept, introduced in his book "Good to Great," represents a powerful metaphor for sustained long-term growth and success. The flywheel metaphor refers to a massive, heavy wheel that takes substantial effort to set in motion. However, once it starts rotating, it gains momentum, making subsequent rotations increasingly easier and more powerful.

In the context of researching companies for long-term growth investments, the flywheel concept suggests identifying companies with self-reinforcing cycles that drive sustainable growth. Here are some flywheel characteristics we look for in our investment process:

Graphic Source: Polen Capital Small Company Growth Presentation

1. Uniquely Positioned Businesses

It's imperative to us that businesses establish competitive advantages, no matter what industry they operate in. Otherwise, any excess profits to be had in the industry will attract competition, and without competitive advantages (Moat), the business will lose market share to industry rivals.

Some examples of competitive advantages are:

- <u>Intellectual Property/Intangible Assets</u> – Patents, trademarks, copyrights, trade secrets, brand loyalty.
- <u>Network Effects</u> – When the value of the product/service increases as more people use it.
- <u>Switching Costs</u> – Costs incurred by customers when switching from one product to another.
- <u>Cost Leadership</u> – Via economies of scale, proprietary technology, or efficient supply chain management.

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2. Repeatable Sales Process

This sounds rudimentary, but in order for a business to grow consistently, there needs to be a foundation in place to drive sales that is both repeatable and value-additive.

As a result, we favor businesses that generate a high degree of recurring revenue, such as software-as-a-service and pharmaceutical businesses. Furthermore, it is important to us that the product or service has an attractive customer value proposition, which leads to strong demand and high customer satisfaction. Without the quality control aspect, even the most repeatable sales process will have difficulty attracting customers who stay long-term.

3. Robust Business Model

We expect high-quality businesses to be "masters of their own destiny." To us, this means generating healthy free cash flows and not depending on external capital sources to fund their growth. In our opinion, a company that can organically self-fund growth will be more resilient in times of market stress than a company relying on debt or equity funding.

For over a decade, numerous companies that were unprofitable and burning through cash took advantage of extremely low-interest rates and ample liquidity to fund their operations. Now that liquidity is tighter, and rates are higher, increased borrowing costs could become a significant headwind for debt-laden companies at a time of rising input costs and economic uncertainty.

In contrast, we believe that companies with high earnings visibility, abundant free cash flow, high returns on invested capital, and a strong liquidity profile offer a margin of safety in case of an economic slowdown.

4. Effective Management

Another crucial component of high-quality businesses is that they tend to be led by exceptional management teams. We value companies that have embraced a culture of professionalism, humility, and trust. We have found that staying disciplined to a long-term vision and not deviating to chase near-term profits is a critical factor of business success.

In the 1960s, a Stanford professor named Walter Mischel began conducting a series of important psychological studies. One of these studies became known as "The Marshmallow Experiment," whereby hundreds of children were taken to a room, sat in a chair, and given a single marshmallow. At this point, the researcher offered the child a deal. The researcher told the child that she was going to leave the room, and if the child did not eat the marshmallow while she was away, then they would be rewarded with a second marshmallow.

The choice was simple: a single treat right now or two treats later.

As the years rolled on and the children grew up, the researchers conducted follow-up studies and tracked each child's progress in several areas. What they found was the children that were willing to

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delay gratification and waited to receive the second marshmallow ended up having higher SAT scores, lower levels of substance abuse, better responses to stress, and generally scored better in a range of other life measures.

To summarize, we search for these same qualities in managers who must show the ability to, at times, sacrifice the quick, short-lived successes for the longer-term, lasting success of the 20 Mile March.

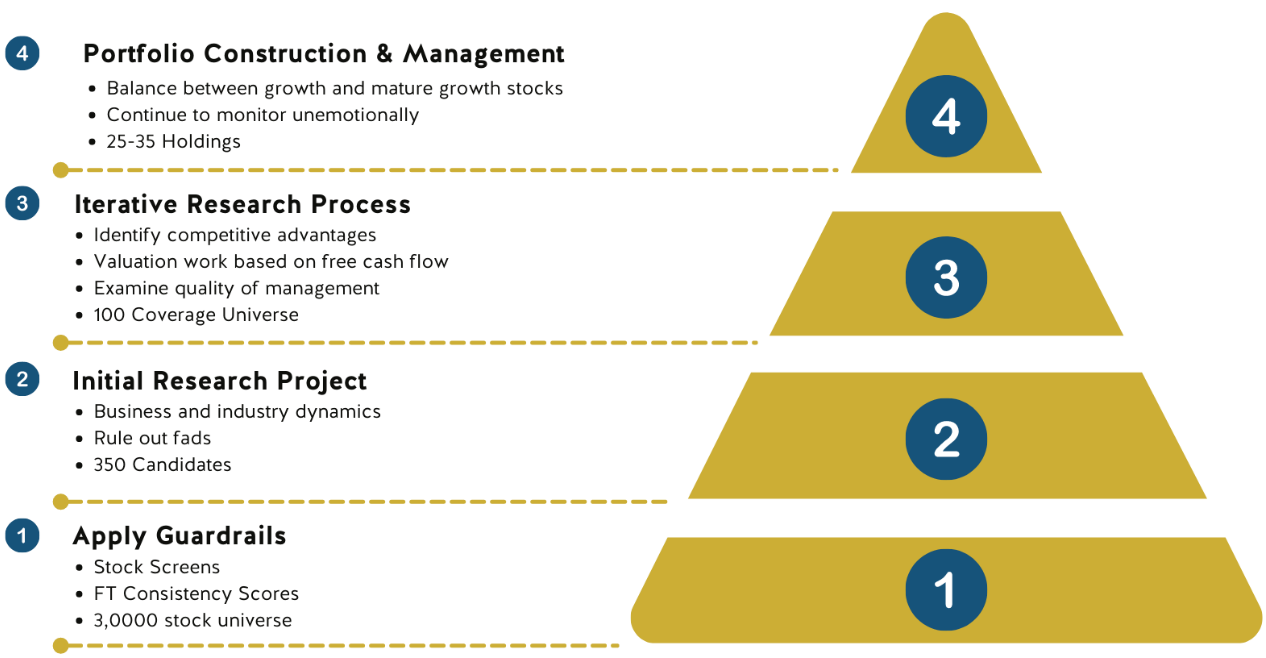
5. Value-Creating Reinvestment

Going hand and hand with effective management is a broader team we call capital stewardship. Is management reinvesting in the business to help expand its core brand? Is there evidence of a road map and reinvestment acumen via disciplined capital allocation decisions?

Businesses can elongate their growth runway by reinvesting back into the business. Whether through Research & Development (R&D), growth Capital Expenditures (CAPEX), or value-additive mergers & acquisitions, reinvestment can provide opportunities to keep the flywheel in motion.

Investment Framework

There are thousands of companies we can invest in globally. How do we filter out stocks that do not meet our minimum criteria quickly and efficiently so we can spend the bulk of our time researching what we believe are the highest-quality growth companies to build a lean portfolio of 25-35 stocks?



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1. Apply the Guardrails

We invest a lot of money in our research technology. One software we rely heavily on is FactSet, where we have engineered proprietary stock screening tools that rank companies based on different investment characteristics, such as earnings growth over the last five years, return on invested capital, liquidity ratios, and many more.

We also created a metric that we refer to as the FourThought Consistency Score, which is a statistical analysis of earnings growth over time. We take historical earnings growth rates for companies, measure the standard deviation of that growth, and then adjust so we aren't penalizing high-growth companies. The result is a number that we can use to compare the consistency of earnings growth for any company, no matter what stage in the growth cycle they are.

The big picture is that averages don't tell the full story. Two companies can have the same average earnings growth over the past five years yet have extremely different paths to get there. We prefer the path of high consistency and low volatility.

2. Initial Research Project

After we have screened out the bulk of securities that don't meet our criteria, we move to further limit our list of stocks by looking at the underlying businesses at a high level to assess if the company has a Moat. We may have 300-400 companies, or approximately 20-30 in each sector that pass the initial screening. We use FactSet and/or Morningstar to determine if the company possesses any material competitive advantages, as described earlier in the paper.

In this stage of the project, we can quickly eliminate companies that have no competitive advantages or very weak sources of a moat and limit the list to about 100 stocks in total.

3. Iterative Company Research

This stage takes up the most amount of time as we strive for a deep understanding of the business and underlying economics that drive the companies' performance. We examine both quantitative trends and qualitative traits of the business and management teams.

We must understand the business, industry, competition, customers, and suppliers to a high degree to give accurate forecasted future cash flow estimates. We then discount those future cash flows back to today (called intrinsic value) and compare them to what the market is valuing the common stock. Often, we will wait for the market to present shares trading at a material discount to fair value; we will want to buy these companies and own them for a long time.

4. Portfolio Construction & Management

With this strategy, we have a relatively modest turnover rate as we strive to buy and hold great businesses. Overall, we maintain a balance between mature growth stocks and higher growth stocks. We monitor the portfolio unemotionally and actively search for any biases clouding our judgment.

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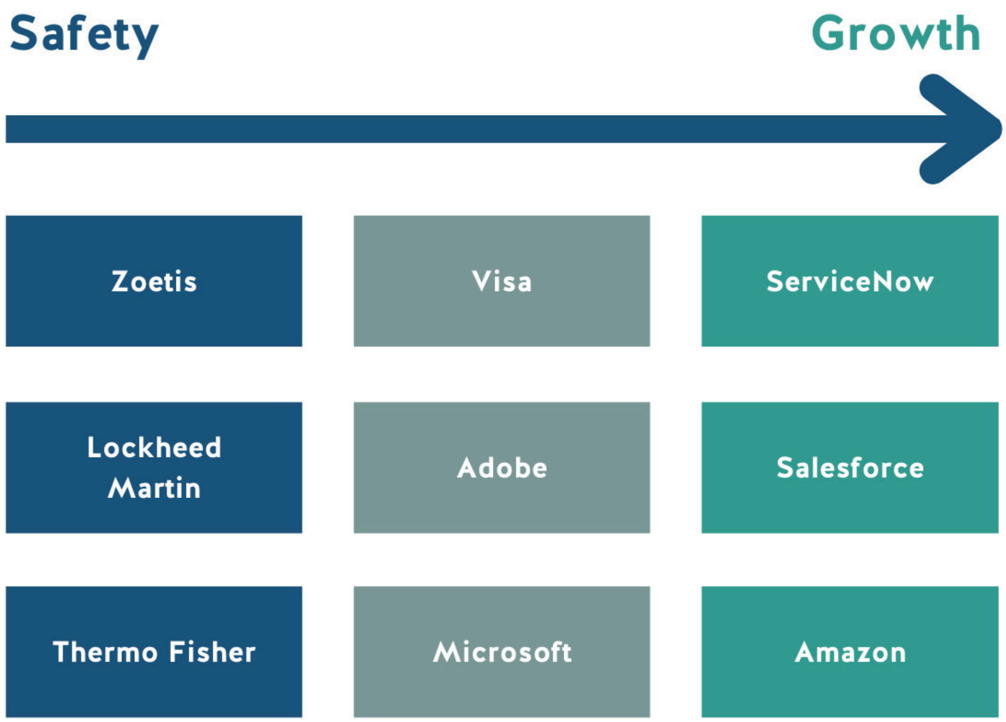
We have buy/sell decisions that are strictly rules-based. We will sell a company if there is a material shift in the business, thus impairing our investment thesis, or if better opportunities exist. We may trim when our guardrails signal uncertainty. We will buy more when short-term issues in the market provide a material discount to our intrinsic value.



Case Studies

1. Zoetis (ZTS)

Zoetis is on the ‘Safety’ end of the growth spectrum because it is a mature business founded in 1952, with consistent yet moderate growth. Zoetis is an undisputed leader in the global animal health industry. The company engages in the discovery, development, manufacturing, and commercialization of medicines, vaccines, diagnostic products & services, and genetic tests for animals across the globe.

According to our research, secular tailwinds in the industry from personal pets and commercial livestock support growth in the mid-double-digit range over the next 5-10 years. Zoetis can convert revenue into profits and reinvest at high rates (high Return on Invested Capital), which has helped the business achieve high rates of earnings growth.

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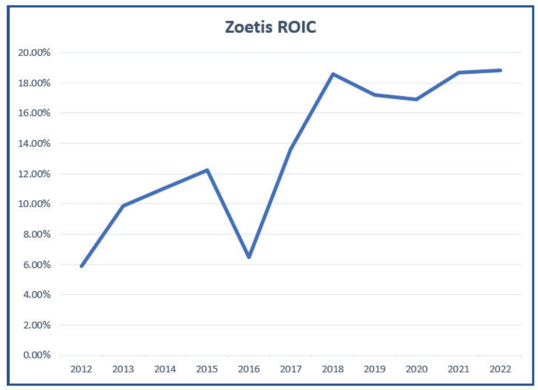
Zoetis has created competitive advantages through pricing power, a high degree of intangible assets, and cost advantages via an efficient scale.

Case Study#1 Zoetis (ZTS)

- Undisputed leader in the global animal health industry
- Secular tailwinds in the industry support growth in the mid-double-digit range
- Competitive advantages:
    1. Pricing power
    2. Intangible assets (patents)
    3. Cost advantages
- Value-creation through reinvestment into the business with high profitability

Source: FactSet Global Research



2. Visa (V)

Most immediately recognize Visa as an established market leader in the global payments industry. We believe that secular tailwinds coupled with scalability should allow Visa to grow earnings in the mid-double-digits over the next 5+ years. As a result, Visa would fall into the middle of the Safety vs. Growth spectrum.

Visa has robust network effects, immense barriers to entry, and significant cost advantages which provide protection from their competition (a wide moat).

The high levels of free cash flow that Visa has achieved over the last ten years allow management flexibility to reinvest back in the business, pay a dividend, and buy back shares.

Case Study#2 Visa (V)

- Established market leader in the global payments industry
- Secular tailwinds and scalability should allow V to grow in the mid double-digits over the long term
- Competitive advantages:
    1. Robust network effects
    2. Immense barriers to entry
    3. Cost advantages
- High levels of free cash flow give optionality to reinvest in the business, pay a dividend and buy back shares

Source: FactSet Global Research

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3. ServiceNow (NOW)

ServiceNow could be a company you've never heard of, but they have been around for just under 20 years now after its establishment in 2004. NOW has developed into an emerging market leader in the enterprise software industry.

ServiceNow is a company that provides software solutions to help businesses manage their work processes more efficiently. The platform allows businesses to automate and manage different processes, such as IT service management, customer service, human resources, and more. It acts as a central hub where employees can access the tools they need to get their work done effectively.

ServiceNow is used by a wide range of businesses across various industries. Many well-known companies and organizations, including JPMorgan, General Electric, and Coca-Cola, rely on ServiceNow's software platform to streamline their work processes and enhance efficiency.

Success has been rapid and notably organic as ServiceNow has grown its customer base and has some of the best customer retention numbers in the industry, leading to a high degree of recurring revenue. ServiceNow has competitive advantages in its strong network effects and high customer switching costs. Furthermore, their software is highly scalable, and significant economies of scale exist.

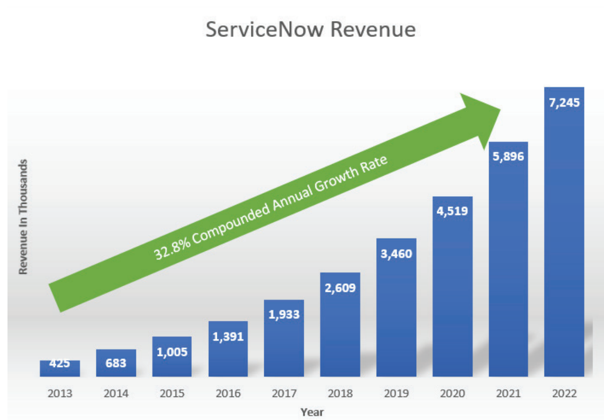
Case Study#3 ServiceNow (NOW)

- Emerging market leader in the enterprise software industry
- Success has been rapid and notably organic with elite customer retention
- Strong retention + stable customers=highly recurring revenue stream
- Competitive advantages:

1. Robust network effects
2. High customer switching costs

- Software is highly scalable and significant economies of scale exist

Source: FactSet Global Research



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Conclusion

Our FourThought Consistent Growers strategy has started off well in the first quarter of 2023. This was a result of the strategy's position in high-quality stocks due to our consistency bias, low turnover, and long-time horizon approach.

Our bias towards targeting companies with a consistent growth track record guides us to great companies with management teams that align their dividend policy with the profitability of the firm.

Another bias of the strategy is to invest in companies with durable competitive advantages. We believe that without competitive advantages, any short-term success will be lost in competition. We focus on companies with wide protective moats that limit the ability of competition to encroach on their business.

One core principle is that "We are not Gods." We can't predict what is going to happen. However, we are confident in the decision-making of world-class companies to navigate the risks.

Empirically speaking, we know that the market is forward-looking and will likely bottom well before the economy bottoms. Staying the course and focusing on a diversified portfolio of high-quality growth stocks is critical to achieving your investing goals.