2021 Annual Letter

Dear Clients,

Last year I wrote that "this letter does not, and will never, serve as a venue for market predictions." 2021 perfectly captured the futile nature of predictions. I don't profess to have any special aptitude for forecasting macroeconomic events. However, even if I did, I would be hard pressed to have anticipated the rise of meme stocks, the turbulence in Afghanistan, the proliferation of Covid variants (by next year we might be out of Greek letters), or the odd dynamics playing out with the supply chain and inflation. And even if I had seen all of those things coming, I would not have predicted markets appreciating so significantly!

The good news is we don't need to make annual predictions to do our job well. We know what our task is (to build and preserve client wealth over the long term) and we know what we need to do in order to achieve these goals. Our philosophy on building wealth remains the same as it was last year: **Snowballs and Singles**.

To paraphrase the words of the author Morgan Housel, we are not worried about earning the highest returns in 2022, we are focused on figuring out how to sustain the best returns through 2072. To do this, we must avoid permanent capital impairment, we must continue to buy great companies at good prices, and we must lay out strong financial plans for clients to ensure the durability, resiliency, and longevity of their portfolios. The steps are simple, but the execution is difficult. That difficulty happens to be why our business exists. If it was easy, everyone would do it themselves!

I think that by avoiding the noise of quarter to quarter stock moves and figuring out how much GDP will rise next month, we actually act as better stewards of capital. It is foolish to confuse activity with productivity. Every minute our attention is not squandered on the news of the moment is another minute we can pore through a 10-K, find scuttlebutt on a company, or dive deeper into an industry. That is what moves the needle, not getting next quarter's Consumer Price Index down to the hundredth decimal point.

I have no idea what will happen in 2022 from an overall market perspective. Where the S&P goes from here in the next day, month, or year, is beyond me. We are not market timers and never will be. This ebullient atmosphere of elevated valuations could persist for years. Or the market could crash tomorrow. It is impossible to know.

Davidson Kahn is a registered investment adviser. Information presented is for educational purposes only. It should not be considered specific investment advice, does not take into consideration your specific situation, and does not intend to make an offer or solicitation for the sale or purchase of any securities or investment strategies. Investments involve risk and are not guaranteed. Be sure to consult with a qualified financial adviser and/or tax professional before implementing any strategy discussed herein.

14011 Ventura Blvd
Suite 302
Sherman Oaks, CA 91423

I can tell you that we are well positioned as stewards of your capital in any scenario. We make purchases when we find we are getting excellent value for the price we are paying. There were many moments in 2021 when this was the case and I believe that will continue to ring true in the future. We do not buy companies looking to sell them in six months or a year, so annual predictions don't do us much good anyways. As Warren Buffett wrote in 1996, "If you aren't willing to own a stock for ten years, don't even think about owning it for ten minutes." That is the approach we take at Davidson Kahn. While tomorrow is uncertain, I do believe that over the long term, the engines of innovation and ingenuity will continue to power American prosperity and growth.

In this year's letter, I will share with you when the power of compound interest clicked for me, the importance of free cash flow and return on invested capital for any company, and an update on Davidson Kahn.

Dodge and Cox

It was Passover (a Jewish holiday) in 2011 that truly opened my eyes to the 8th wonder of the world: compound interest. While I probably should have been a bit more focused on the Israelites suffering in Egypt and our journey through the Red Sea, I was fixated on one name and three numbers: Dodge and Cox, 10%, $5,000 and $12,000,000.

I had learned about compound interest and the rule of 72 long before 2011. The rule of 72 states that you divide 72 by whatever rate of return you are earning on your money to determine how long it will take for your initial principle to double. To illustrate, a return of 10% will double your money in a bit over seven years and a return of 20% doubles it in less than four years.

We have a close family friend who is now in his 60s. I will call him John for the purposes of this letter. John is one of the most personable individuals on the planet. He could sell ice to an Eskimo. In the 1980's John was extraordinarily successful in network marketing and was practically printing money. He had no idea what to do with all of it, so he asked my Zayde (my grandfather) for advice. My Zayde is a meat and potatoes guy when it comes to investing (it runs in the family). He likes to keep it simple and has never been struck by the bug of getting rich quick. He told John to take $5,000 each month and put it in the Dodge and Cox stock fund. This was before the S&P ETF came out and the Dodge and Cox stock fund was a reasonable enough facsimile of "buying the market" (with some differences that are not relevant for this story).

For some historical context, the start of the 1980's was not a time when most individuals felt comfortable investing in stocks. The "go-go" years of the 1960's and the "Nifty 50" had given way to stagflation and a moribund stock market. The famed "death of equities" 1979 Businessweek headline captured the general aversion to equity investing. It was only the truly

Davidson Kahn is a registered investment adviser. Information presented is for educational purposes only. It should not be considered specific investment advice, does not take into consideration your specific situation, and does not intend to make an offer or solicitation for the sale or purchase of any securities or investment strategies. Investments involve risk and are not guaranteed. Be sure to consult with a qualified financial adviser and/or tax professional before implementing any strategy discussed herein.

14011 Ventura Blvd
Suite 302
Sherman Oaks, CA 91423

patient individuals who still felt comfortable buying stocks. Anyone looking to get rich quick was not an investor at the time.

John wanted something a little bit flashier and a little bit more exciting. I have no idea what he ended up investing in, but it certainly wasn't the Dodge and Cox stock fund. Every year, my grandpa would keep telling him to take $5,000 a month and put it into Dodge and Cox. Every year, he would ignore him and chase the new hot idea. John had an incredibly successful 1980's in terms of his earnings, but unfortunately he did not put a dime into the Dodge and Cox stock fund. The 1990's were not as kind to John, and he would not have been able to continue to make $5,000 monthly contributions from that point on.

At Passover in 2011, I heard this story for the first time. John asked me how much money I thought he would have if he had just invested $5,000 a month every month for ten years in that Dodge and Cox stock fund. In total, he would have had invested $600,000. My Zayde wasn't sure of the exact annualized return of the mutual fund since 1980 but he thought it was somewhere around 10% (which is about what the market has returned as a whole historically).

I thought he might have quadrupled or quintupled his money in that time period, leaving him with a few million dollars. After we pulled up an online compound interest calculator, it turns out if he had just invested that $5,000 a month for 10 years and never invested another dollar (nor sold any of the Dodge and Cox fund), he would have had more than $12,000,000! I will never forget two things about that moment: John's facing turning pale white as he realized how much money he could have had and the lightbulb going off in my head about the power of compound interest.

My Sister got married recently and John was there. Since I don't enjoy inflicting emotional pain on others, I avoided bringing up the Dodge and Cox story or mentioning how much money John would have in 2021. However, I did run a quick calculation myself. At the end of this year, had John left that initial $600,000 invested, it would now be worth more than $32,000,000! That is from simply saving $600,000 over a ten-year period and letting the money do the rest of the work!

Most clients will recognize this story as it serves as the bedrock principle of my **"Snowballs and Singles**" philosophy. In order to have that $32,000,000, John didn't need to buy the next Apple or Bitcoin. All he had to do was buy the market (or a reasonable approximation of it) and stay disciplined and patient. Of course, not everyone makes nearly as much money as John did. However, any individual investor can save money each month and add it to their snowball.

In order for John to have actually had this money though, he would have needed to maintain immense discipline and emotional stoicism. He would have needed to start investing when people thought the stock market was a graveyard. He would have needed to stay invested

Davidson Kahn is a registered investment adviser. Information presented is for educational purposes only. It should not be considered specific investment advice, does not take into consideration your specific situation, and does not intend to make an offer or solicitation for the sale or purchase of any securities or investment strategies. Investments involve risk and are not guaranteed. Be sure to consult with a qualified financial adviser and/or tax professional before implementing any strategy discussed herein.

14011 Ventura Blvd
Suite 302
Sherman Oaks, CA 91423

through Black Monday in 1987, the Savings and Loan Crisis, the 1997 Asian Financial Crisis, the Dotcom bubble, 9/11, the Great Recession, and Covid 19.

He would have needed to stay the course through years of underperformance. He would have needed to maintain the mental fortitude to avoid the next "hot stock" or piling in to a fund his neighbor or cousin made a small fortune on. He would have needed to be boring, not regaling his dinner party guests with his latest stock purchase or trading based on what a CNBC commentator said. I know John really well, and I can say with absolute certainty that there is zero chance he would ever stay invested in the same stock fund for more than forty years. While it is unfortunate for him, it makes for a great story for this letter.

John isn't unique in this regard. Most people lack discipline or a long-term plan when it comes to personal finance. They want to get rich right away, and they clip together forty years of one-year strategies, instead of maintaining one forty-year plan.

John didn't need to beat the market or get fancy to have generational wealth. He just needed discipline and patience. I don't know if we will beat the market over the next 40 years. I certainly hope we will as I dedicate most of my waking hours to doing just that, but there is no guarantee. I do know that if we help create client plans to put away money each month and we avoid panic selling and avoid overpaying for assets, we will all be more than fine.

Anytime I speak to a new client, I think of that Dodge and Cox story. Decades from now, I want all of you to be telling your families "Davidson Kahn" stories: about how setting aside some monetary amount each month for a long period of time created or maintained wealth that will last for generations to come. We don't want our clients to be John wondering about what could have been; we want everyone in the Davidson Kahn world to look back with nothing but satisfaction for having built wealth slowly.

Free Cash Flow and Return on Invested Capital

There are countless attributes I look for in a business and there is no one characteristic that can make a company a sure thing. However, if I were to just pick two metrics that are the most important in identifying high quality businesses, they would be **free cash flow and return on invested capital.**

First, **free cash flow** which I think of as **"owner earnings."** Warren Buffet coined the term owner earnings as the amount of cash a business could pull out each year while still maintaining any existing competitive advantages. This is different than net income, because it accounts for the fact that most companies must make ongoing capital expenditures (separate from their day to day operating expenses) to ensure their continued vitality.

Davidson Kahn is a registered investment adviser. Information presented is for educational purposes only. It should not be considered specific investment advice, does not take into consideration your specific situation, and does not intend to make an offer or solicitation for the sale or purchase of any securities or investment strategies. Investments involve risk and are not guaranteed. Be sure to consult with a qualified financial adviser and/or tax professional before implementing any strategy discussed herein.

14011 Ventura Blvd
Suite 302
Sherman Oaks, CA 91423

Let's say you own an airline (I wouldn't recommend it). If after all of your operational expenses and debt payments, you were to earn $10,000,000 annually, you might think that you had a great business. However, if every two years you needed to spend $8,000,000 to maintain your existing fleet of planes, then you really cannot take out $10,000,000 dollars a year. You have to leave $4,000,000 in each year in order to pay for that maintenance every other year. And then, you might have to buy new planes every decade which hypothetically might cost $75,000,000. This means you would be leaving all of your remaining net income in the business for future aircraft purchases.

It turns out, not only is every penny of that $10,000,000 of annual income accounted for just to maintain your business, but you might actually have to invest more just to keep your fleet of planes operational! In this case, you would have negative owner earnings, spending more than you make just to run in place. While these numbers might be an exaggeration, you won't see us buying airline companies anytime soon.

On the other hand, let's say you own a chain of lemonade stands. The lemonade stands are incredibly successful, and they make $100,000 a year after all expenses are paid. Every ten years, you will need to buy new tables and new signs. Combined, these will cost you $50,000. So instead of pocketing $100,000 each year, you leave $5,000 in the business and take home $95,000. After ten years, you have the $50,000 set aside that you need to buy the signs and the tables, and you also have $950,000 in your pocket.

On paper, the lemonade stand earns 1/100 of the money that the airline does each year. Yet after ten years, the owner of the lemonade stand has been able to take out close to a million dollars from the business and the airline owner actually had to put more of his or her money back in to company. I know which business I would want to own.

Obviously, this is an incredibly simplistic example as companies can raise new equity or debt to fund capital expenditures, but it shows you the importance of owner earnings. GAAP earnings are just an accounting term that have some importance, but factor very little into my analysis. We only like companies that can produce a tremendous amount of owner earnings. There is no specific type of business that guarantees owner earnings, because even asset lite industries like software and asset management often have fierce competition that require ample reinvestment just to maintain market share. When you find that rare company that has tremendous owner earnings (and a future filled with even more), you smile.

Free cash flow isn't the end all be all though. A company must not only produce tremendous free cash flow, but they have to be talented at reinvesting those cash flows. This is where **return on invested capital** comes into play. When capital comes in, managers have a few choices of how they can allocate that money. They can reinvest it back into the business for growth, they can return it to shareholders through dividends or stock buybacks, they can use it to purchase other businesses, or they can buy fancy jets and lavish dinners. There is no right

Davidson Kahn is a registered investment adviser. Information presented is for educational purposes only. It should not be considered specific investment advice, does not take into consideration your specific situation, and does not intend to make an offer or solicitation for the sale or purchase of any securities or investment strategies. Investments involve risk and are not guaranteed. Be sure to consult with a qualified financial adviser and/or tax professional before implementing any strategy discussed herein.

14011 Ventura Blvd
Suite 302
Sherman Oaks, CA 91423

answer (minus the jets, that probably is never a good idea) of how management should allocate their excess capital. It is completely situational dependent.

In an ideal world, we want our managers to take any excess cash flow and reinvest it back into the business. However, we only want them to do this if their investment options yield a return that is greater than we could get if they returned the money to us. This is where return on invested capital comes in.

Before we get into what return on invested capital means, I want to emphasize how critical this metric is for every single business over a long-time horizon. Since we plan to own all of our businesses for decades, how well management at the companies we own allocate capital will be the single largest determinant of our investing success. Every company we own produces a prodigious amount of free cash flow, but they also have a demonstrated track record of superbly allocating that capital. It doesn't matter if a company generates billions of dollars in free cash flow each year. If they invest it poorly, eventually that business will lose its value.

There are two things we look at when analyzing return on invested capital. First, is how well a company has historically invested their excess free cash flow. There are a handful of numerical formulas to calculate return on invested capital, but ultimately it boils down to figuring out the amount of money a company earns (their operating income) and dividing that by the total capital the company uses in its operations (any land, machinery, debt, inventory or anything else that is needed to run the business including in some instances income statement items as well). The higher the ROIC (return on invested capital) the better.

However, historical ROIC doesn't give you the full picture. While it does tell us if management has a demonstrated track record of strong capital allocation (without it, we would be hard pressed to invest), this doesn't mean much if future return on invested capital prospects are not as exciting. This is where things get interesting. Our job is to figure out if a company has the ability to have a high return on incremental invested capital (ROIIC). In other words, will the business be able to invest future free cash flows at extremely high rates. The longer a company can do so, and the higher the rates, the more valuable the business.

To give you a concrete example, imagine a paper company that has retail stores. Historically, the paper store has been able to open up a new retail store for $2,000,000. In year 1, the store on its own makes $300,000. In year 2, it starts really doing well and makes $700,000. In year 3, it makes $1,000,000. By the end of year 3, you have made back your initial investment and every year after that, the free cash flow that the store produces can be used to invest in more stores.

This is a dream business with an incredibly high ROIC. If you have a payback period of three years, and then you can make $1,000,000 a year on an initial $2,000,000 investment, you are rolling in dough. Unfortunately, those types of numbers will bring in competition. Suddenly,

Davidson Kahn is a registered investment adviser. Information presented is for educational purposes only. It should not be considered specific investment advice, does not take into consideration your specific situation, and does not intend to make an offer or solicitation for the sale or purchase of any securities or investment strategies. Investments involve risk and are not guaranteed. Be sure to consult with a qualified financial adviser and/or tax professional before implementing any strategy discussed herein.

14011 Ventura Blvd
Suite 302
Sherman Oaks, CA 91423

everyone will want to own a paper store. Maybe in the future, instead of it taking three years to make back your money, it takes five. When the store reaches maturity, maybe it only makes $600,000 instead of $1,000,000. Maybe, so many new paper stores go into business that all of the paper stores lose money or just break even. That is capitalism 101. In order to maintain high levels of future ROIIC, a company must have sustainable competitive advantages that would dissuade competitors from starting future paper stores.

I don't think figuring out a company's future ROIIC prospects has ever been easy, but in 2021 it is more difficult than ever. Of course, there are still examples of companies taking their excess cash and opening up new retail stores (RH and one of our newest companies Floor and Décor do exactly that). We own those businesses because we think they can continue to open up stores for years to come and make back their store level investment quickly.

There are also companies like Copart who take a lot of their free cash flow and buy more land to house their inventory of vehicles. We believe every time Copart buys a new piece of property, they make back their money in an unbelievably rapid fashion. It took months to figure out whether or not these great companies could continue to invest at high rates of return well into the future, and while I am very confident they will be able to, there is no guarantee.

These companies were on the easier end to analyze. In 2021, when software is eating the world, you often have to figure out if the amount that companies invest acquiring new clients or customers is worth the lifetime value of the customer (Charles Schwab and Etsy come to mind). Or in the case of Brookfield Asset Management, we have to be comfortable with the idea that the future investment products and funds that Brookfield spends money creating will generate future asset management revenue streams that far exceed the original amount invested (I am confident in this too).

Some of the companies we own (Berkshire Hathaway, Markel, and Constellation Software) derive a large portion of their value from their respective management's ability to deploy capital by acquiring other businesses. These are not the traditional definitions of return on invested capital, but the mental framework of figuring out if the businesses we own will be able to adequately deploy the mountains of cash they generate is at the heart of our investment process.

If over a twenty-year period, a company that is currently worth 10 billion dollars generates a collective 25 billion dollars of excess cash flow, how management of this enterprise deploys all of that future money will determine whether the company is worth 50-100 billion dollars two decades from now or simply treading water. That is why the ability of management and the future investment opportunities of any business we invest in are so critical.

Davidson Kahn is a registered investment adviser. Information presented is for educational purposes only. It should not be considered specific investment advice, does not take into consideration your specific situation, and does not intend to make an offer or solicitation for the sale or purchase of any securities or investment strategies. Investments involve risk and are not guaranteed. Be sure to consult with a qualified financial adviser and/or tax professional before implementing any strategy discussed herein.

DAVIDSON KAHN
CAPITAL MANAGEMENT

14011 Ventura Blvd
Suite 302
Sherman Oaks, CA 91423

Davidson Kahn

2021 was another great for Davidson Kahn and we are so appreciative of every single client's trust and support. Much like the companies we buy, internally we focus on the inputs and figure that the outputs will take care of themselves.

I don't worry about what our assets under management are or how our portfolio performed against the S&P over the last three months. If our process is strong, those things will take care of themselves over the long term.

This year, we were able to diligence more than 150 companies. We learned about a handful of great companies and because most high-quality companies are priced that way, we only added a few to the portfolio. However, these diamonds were worth the thousands of hours of research it took to get there. All of the new companies are ones I am comfortable owning for a very long time and they have everything we want: a great business model, tailwinds for growth, superb and honest management, tremendous free cash flow, excellent historical return on invested capital metrics and a clear path for high levels of future returns on incremental invested capital. It doesn't matter if it is a vertical market software aggregator (Topicus), an online marketplace (Etsy), or a retail flooring company (Floor and Décor). Great businesses come in many shapes and sizes, and it is our job to find new companies each year that we all can own for decades.

I was pleased with the other inputs as well. We spent zero dollars on marketing, we had a 100% client retention rate, and we were able to average more than five hours a day of uninterrupted reading and research.

The outputs weren't too shabby either. We more than doubled the amount of assets we manage (that growth rate will decelerate over time) and many of our companies had banner years in terms of growing their free cash flow per share and making excellent strategic decisions. I purposely exclude the share price performance of our companies on an annual basis as it is irrelevant. Some of our companies had excellent share price appreciation, others did not. However, I am as confident as ever in all of their future prospects.

2021 was another year for the history books and I hope everyone is able to stay healthy and safe in 2022. I cannot thank you enough for your trust in me. It bears repeating that it is an immense privilege to manage your money and it is one I do not take lightly.

I will repeat a story from last year's letter. When I was at USC I met a girl who was from Omaha, Nebraska. Naturally, I asked her if she somehow knew Warren Buffett. She didn't. However, she did say he was responsible for her going to college. It turns out her grandparents bought Berkshire stock decades ago, and whenever a grandkid was ready to go to college, they sold a share or two to pay for the tuition.

Davidson Kahn is a registered investment adviser. Information presented is for educational purposes only. It should not be considered specific investment advice, does not take into consideration your specific situation, and does not intend to make an offer or solicitation for the sale or purchase of any securities or investment strategies. Investments involve risk and are not guaranteed. Be sure to consult with a qualified financial adviser and/or tax professional before implementing any strategy discussed herein.

14011 Ventura Blvd
Suite 302
Sherman Oaks, CA 91423

That story has always stuck with me. My goal is that one day in the distant future, clients, as well as kids and grandkids of clients, will say that investing with Davidson Kahn helped pay for college, their first home, a large charitable bequest or any other meaningful item or experience. That is the type of wealth we are looking to help build, and, as long as we keep adding to our snowballs and hitting singles year in and year out, I am confident we can do so for much of the 21st century.

Sincerely,

Jake Davidson, JD/CPA

Davidson Kahn is a registered investment adviser. Information presented is for educational purposes only. It should not be considered specific investment advice, does not take into consideration your specific situation, and does not intend to make an offer or solicitation for the sale or purchase of any securities or investment strategies. Investments involve risk and are not guaranteed. Be sure to consult with a qualified financial adviser and/or tax professional before implementing any strategy discussed herein.