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CAPITAL MANAGEMENT

2022 Annual Letter

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"How could he have fooled… the whole brains trust of institutional investing, for as long as he did and, of course, taken the innocent investing public along with them? The answer appears to be painfully simple: that he was plausible and they were gullible as well as greedy; that, in times of speculative madness, the wisdom and experience of the soundest and soberest may yield to hysteria induced by the glimpse of fool's gold dished by a young man with a smile on his lips and a gleam in his eye."

Dear Clients,

If you were to read the quote above, you might think it was a Wall Street Journal columnist waxing eloquently about Sam Bankman-Fried's (allegedly) massive Ponzi scheme.

While that assumption is plausible, it is also wrong. In fact, this quote is more than 50 years old and comes from the great John Brooks' book, *The Go-Go Years*. In this seminal work, Brooks chronicles a time of speculative excess in the 1960s, when "paradigm shifting" technology companies were going public at a rapid clip, and everyone was in a mad dash to get rich.

For much of Brooks' book, you could take out the 1960s, substitute in the early 2020s, and it would be eerily accurate. In the 1960s, there was an undercurrent that the West had failed. America was still enmeshed in the Cold War in a multi-polar world. The country was coming off our "Sputnik" moment when Soviet space technology far eclipsed our own domestic advancements.

Specifically, 1968 was a year of race riots, a contested Democratic National Convention, and a summer where the country seemed to be ripping at the seams. Yet at the same time, markets were rising, Merrill Lynch (which was one of the first brokerage houses to target retail investors) was opening a ton of new accounts and a plethora of low-quality companies were going public as they touted their future potential.

Replace Merrill Lynch with Robinhood, the Soviet Union with China, space technology with our handling of Covid, keep the general societal tension, and that sounds pretty darn similar to 2020-2022.

It doesn't end there. Here are some other quotes from the book:

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"Mutual Funds with large front-end commissions, sometimes amounting to half of the initial investment, were unfair to the small investor- whom the funds were supposed to benefit most. Wall Street replied that such contracts were necessary incentives for the salesmen."

If you change Mutual Fund to SPAC, and commissions to warrants, that quote does a fantastic job of describing what happened in 2020-2022 with SPACS, which will go down as one of the greatest voluntary transfers of wealth from everyday Joes to Wall Street Pros (my 10th grade English teacher would not be impressed with that rhyme scheme).

There are more: "Tsai operated Fidelity Capital Fund in a way that was at the time considered almost gambling. He concentrated money in a few stocks that were then thought to be outrageously speculative and unseasoned for a mutual fund."

This is Brooks describing Gerry Tsai, who for a brief time had an incredibly successful run as a mutual fund manager. You replace Tsai with Wood, and Fidelity Capital Fund with ARK Innovation, and the story repeats itself like clockwork.

I could spend pages on the historical parallels or even jump ahead 30 years. The books *Dot.Con* and *Origins of the Crash* do a great job of capturing the tech bubble at the turn of the millennium. At that time, all the online brokerages were paying ridiculous sums of money for Super Bowl commercials. Within a year, many of those companies were fighting for their lives. In 2022, it was Crypto companies rinsing and repeating.

The books *Secrets of the Temple* and *The Great Inflation* expertly depict the mood of the 1970's and how short-term political decisions and an accommodative federal reserve laid the groundwork for multiple bouts of eye watering inflation. While the inflation story is still being written today, the parallels are pronounced to say the least.

Considering we get paid to grow and preserve your wealth, and not give history lessons, I will stop there. However, I do want to make the point that while history doesn't repeat, it certainly rhymes. The specific idiosyncrasies of 2020-2022 are unique to this moment in history, but the many overarching themes of greed, short term-ism, and FOMO (fear of missing out) were prevalent well before the 2020's and will exist long after.

While we may be students of history, that does not mean we are arrogant enough to think we can predict the future. History gives us a base to work off, but we will never be so reckless as to risk your hard-earned capital on trying to time the market.

I do not know when this bear market will end, but I am quite confident it will end. The good news is that in order to achieve our job, which is to build and preserve your wealth, we don't need to call tops and bottoms in the market. We do need to be aware of history, we need to

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avoid FOMO, and we need to make sure that clients don't panic or are forced to sell in times that are scary and turbulent like in 2022.

2022 was unquestionably a rough year, and all our portfolios were no exception (we invest right alongside our clients, so the pain was felt across the board). We weren't immune from poor performance nor did we expertly time the market and buy a bunch of oil companies. However, much like we don't exuberantly celebrate the good times when everyone is happy and the punch bowl is out, we also don't get down on ourselves or our companies when panic and fear permeate every crevice of society.

Our job is remove emotion, act with reason and discipline, and not have FOMO. We didn't have FOMO for crypto or money losing companies and we won't in the future. This does not mean we will always outperform (or ever) but our decisions are based on reason, ration, and the fundamental laws of arithmetic.

The best behaviors in a bear market are to purchase shares of wonderful businesses trading at lower prices, maintain ownership in great companies that have pricing power and strong returns on capital, and to never panic sell. We did all those things this year as our **Snowballs and Singles strategy** for building long term wealth did not deviate (and it never will).

As I say in every annual letter, "this letter does not, and will never, serve as a venue for market predictions." We are well positioned as stewards of your capital in any scenario, whether the bear market continues, or we have a rebound. We make purchases when we find we are getting excellent value for the price we are paying. There were many moments in 2022 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. 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 the importance of cash at both the individual and company level as well as an update on Davidson Kahn.

Cash is Oxygen (or Valium)…. But Definitely not Trash

As I have mentioned in previous letters, you can suffer a permanent impairment capital in two distinct ways when purchasing stocks.

First, you can grossly overpay for a quality company that is valued at too high of a price to free cash flow multiple. No matter how great the business is, if you overpay, there is a chance you

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will never recover your initial investment. Or it could take decades. Buying Cisco at its tech bubble peak is the paradigmatic example of this mistake. We pay attention to price because it does matter. **There are unequivocally too high of prices to pay for any company, no matter how great the business may be**. When people start to say price doesn't matter, speculative manias are underway (that doesn't mean we know when they will end).

The second way to permanently impair capital from an investment perspective is to buy a low-quality or broken business that has excessive leverage, is losing market share or is struggling to maintain profitability. No matter how low the price is on these businesses, there is a risk that the company will eventually go bankrupt, and you will lose all your money. **Even if the price of a company has already dropped 99%, you can still lose 100% of your money buying at a seemingly discounted price.** These are called value traps.

Our job is to make sure we don't make either mistake. That doesn't mean we will bat a thousand (we won't), but we zealously work to avoid these mistakes to the best of our ability. Impairing your capital is our worst nightmare.

Those are the two ways that one can make an investing mistake that leads to a permanent impairment of capital. However, you can suffer a permanent impairment of capital in other ways unrelated to making a bad investment: panic or forced selling.

This is where the importance of cash comes in. First, it can prevent forced selling. In general, we are not worried when the price of a company we own drops precipitously. (Remember in the short run, the market is a voting machine, but in the long run, it is a weighing machine). We can almost guarantee at some point, every single company we own will suffer a large drop in its stock price. We know that if we are right about the companies' underlying prospects and that we avoided overpaying (and we aren't spending thousands of hours in the office each year for any other reason), the price of the stock should approximate the value over a long enough time horizon. It could take years for this to happen, but that is okay because we are patient.

However, the one time a temporary drop is not okay is when someone is forced to sell. This could be because they lost their job, have other investments that require capital calls, want to buy a house, need to pay for college, or are going to retire soon. Whatever the case may be, if one must sell at the wrong time because they need cash, then a stock dropping to a level that does not reflect its economic value (even temporarily) is a problem.

We guard against forced selling by making sure all our clients have ample liquidity outside of their managed accounts. It may make us overly conservative to recommend large emergency savings funds (well beyond what many financial planners might recommend) or to not invest client's money that they may need in the next few years. However, this ensures that our clients don't have to sell at the wrong time. We would rather manage less of a client's money if it means clients can sleep well knowing they won't need to tap on their managed accounts for a long time. While 2022 is a small sample size, this plan worked over the last twelve months.

To quote Warren Buffett and Charlie Munger, we don't want clients to risk what they have and need, for what they don't have and don't need. If someone has a child going to college in three years, that future tuition money should not be invested in equities in our opinion. The extra couple of percentage points one might earn by keeping it invested for a teensy bit longer is not worth the risk of a massive drawdown. We don't make a habit of picking up pennies in front of the proverbial steamroller, because eventually the steamroller wins.

In addition to forced selling, there is panic selling. Cash matters here as well. If cash is like oxygen for forced selling (you need air to breathe and you need cash to live), cash is like valium for panic selling (credit to Bruce Berkowitz for the metaphor). We always gauge the emotional temperament of clients before we manage their money. If we ever have someone ask us where we think the market is going in the next three months in an introductory call, we usually don't make it to a second call. Likewise, if we determine that a potential client can't handle a significant temporary diminution in the value of their portfolio, they won't be a client.

Even though our clients have excellent emotional temperaments and the stomach to handle the vicissitudes of the market on the journey to long term wealth creation, it is still our job to make sure that no one panic sells. We do this by communicating the wonderful collection of assets clients own and consistently emphasize that temporary drawdowns like the one experienced in 2022 should not affect their long-term wealth building plans.

For clients who still have ample cash flow coming in each year to invest (either from other investments, their primary jobs, ownership in business or real estate), the best thing to happen would be depressed prices for a long period of time. This way clients can pay less per dollar of cash flow for wonderful companies, enhancing future prospective returns. For those who are past the peak of their earning years, we make sure they have enough cash on hand to withstand long periods of depressed prices, so they don't panic or run out of money.

If my wife walked into Nordstroms and everything was massively discounted, she would have a party. When stock prices are down, and you have tons of cash or more cash coming in, you should celebrate! This phenomenon has happened many times throughout the last hundred years. There were great extended buying periods after the depression, in the 1970s and after the lost decade of the 2000's. For those who have a lot of future cash coming in, down markets are not a time to panic, but instead a time to go on the offensive.

2022 was a great year to put money to work. I occasionally got the question, "how do you know X company's price won't go down further." **To be very clear, I don't know that the price of a company we purchase won't go down further. We rarely (if ever) bottom tick our purchases.**

However, we invest when price meets value and the future prospective returns are above our hurdle rate. I will paraphrase a recent quote from Bruce Flatt, the CEO of Brookfield Corporation who captures our perspective on making purchasing decisions. “Returns could get better (the price could go down), but you have to invest when you get good returns.”

By framing lower prices as a buying opportunity for clients (as a result of having cash available), we turn a potential panic sale situation into a buying opportunity, enhancing long term results. **Cash is not trash (even in a low interest rate environment). It provides optionality, security, safety, and reassurance and it helps clients achieve their long-term results.**

Cash is King at the Company Level

As important as cash is at the individual level, it is even more paramount for the companies we invest in. Last year we discussed why free cash flow and return on incremental invested capital are the two things we pay most attention to when we evaluate businesses. To summarize, we plan to own our companies for extremely long time periods. The bulk of the future value creation will be from the reinvestment of the free cash that the company generates each year. If the executives in charge of capital allocation are not skilled, and there are not good opportunities for reinvestment, we won’t own the business.

Those are key qualitative requirements for us to add a company to our portfolio (and finding companies that do this and are priced fairly is no easy task). Of equal importance to us is a strong, fortress-like balance sheet, which we define as having low leverage, an ample amount of cash or cash like instruments, and clear access to liquidity.

To borrow a term from law school, having cash and cash generating abilities is a necessary, but not sufficient, attribute for a company to be worthy of investment. By this we mean that if a business doesn’t have cash and future cash flow, we won’t own the company. However, there are plenty of companies with lots of cash and good cash flow that we would never buy. Think of it as a hygiene factor. No one gets credit for brushing their teeth, but if you don’t brush your teeth, no one will spend time with you. That is how we feel about money losing businesses or those with lots of leverage. Like they have onion breath.

This requirement will remove great companies from our investment universe. Domino’s Pizza is an example. They have a great capital-lite business, franchising many of their restaurants and enjoying a strong stream of licensing fees. However, they have employed what I feel is a risky capital structure. They borrow money to buy back stock. This has worked wonderfully for them and their shareholders, but we would not own a business like this. **(We don’t need to own every successful business to have successful results, a critically important point).**

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We invest probabilistically and we want our decision quality to be high. We try to determine what would create consistently favorable outcomes in 1000 different scenarios. There are just too many potentially adverse outcomes within those 1000 scenarios when leverage is involved.

More than that, companies that don't have a lot of cash or generate cash flow fail to control their own destiny. If a company cannot survive from the cash on its balance sheet and future cash generated from the operations of the business (not from selling assets), it is at the mercy of strangers. And unfortunately, strangers on Wall Street don't tend to be too kind.

Eventually, a company will be forced to raise more cash. Usually, this will be in a time of economic distress where the price of the company's equity has taken a dramatic haircut and debt financing terms are onerous. The options are not very pretty. A company will need to sell equity and dilute existing shareholders. This is the opposite of what we want. We want our businesses to buy back stock when it is cheap and sell equity at inflated prices.

Or a company in desperate need of cash will borrow money and be stuck with huge interest payments, an impaired capital structure, and potential dilution from toxic converts down the road. They may avoid bankruptcy temporarily, but the future is ugly. (This is what will likely happen to many of the cruise ships and airlines who needed emergency financing in 2020).

Whatever the case, if a company is not in control of its own destiny, the viability of that business as an enduring enterprise leaves much to be desired. **For us to own companies for decades, they first must survive for decades**. Cash is critical for survival (hence, oxygen).

This is one more reason we don't buy money losing growth companies. First, I am not nearly smart enough to know which company will be the next Amazon two decades from now. Probabilistically, it is more likely that these companies go the way of Webvan or TheGlobe.com. Secondly, even Amazon needed to raise capital at the perfect time to avoid bankruptcy and there are many alternate scenarios where Amazon doesn't exist today.

Cash also provides optionality for our companies. We spoke about capital allocation at length last year and gave it a brief mention a few paragraphs ago. The companies we own have some of the best capital allocators in the world. Having cash during downturns allows these companies to go on the offensive in recessions. While other companies are worried about simply surviving, our businesses can take market share (Floor and Décor, Alphabet, and Charles Schwab), buy back stock at value enhancing prices (Markel, Berkshire, and Apple), expand operations (Copart, RH, Brookfield, Etsy, and Walker Dunlop), or make great acquisitions (Microsoft, Amazon, Constellation Software, and Topicus). We won't see all the fruits of these decisions for years, but having that optionality coupled with excellent operational ability and shrewd capital allocation is a potent cocktail for long term value creation.

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We don't mind if companies are patient and pile up cash on their balance sheet. Copart has done that for years as has Berkshire. Eventually, that cash will be put to good use. In fact, being patient and avoiding impulsive decisions is one of the things that drew us to a new company in the portfolio this year: Costar Group. Andy Florance, the CEO since inception more than thirty years ago, has demonstrated over multiple cycles one of the best combinations of operational ability and capital allocation I have ever seen. He will stack cash for years (as he is doing right now), pounce on distressed assets, and then reignite growth. Investors who invest quarter to quarter might want Costar to buy back stock to enhance short term metrics, but as a long-term owner, we want Florance and his team to be patient and wait to buy the next great franchise (like they have done with Loopnet, Apartments.com, and many more).

As an aside, our purchase of Costar shows the value of patience, reading, and a long-term approach. We first discovered Costar when doing diligence on Walker Dunlop (a portfolio company) a long time ago. Willy Walker, the CEO of Walker Dunlop, and Andy Florance were neighbors and Florance served on the Walker Dunlop board. When I was reading about the board of directors, it led me down the rabbit hole to Costar. After conversing with tens of real estate professionals, I discovered that Costar might have one of the most dominant positions of any company in any industry as an information provider and advertiser (among other functions). However, Costar has been too expensive (with good reason) for much of the last decade. Finally, this year, for the most fleeting of moments, the company was at a fair price based on my analysis (certainly not cheap) and clients at that time became owners. I am excited for all of us to own Costar for a very long time.

An Update on Davidson Kahn

Despite the turbulent market, 2022 was a great year for Davidson Kahn. We continued to manage money for all our wonderful clients who we plan to be managing money for in 2042, 2062, and even 2082! We also were able to meet and work with great new individuals, families, and institutions this year and look forward to decades of prosperous relationships.

We still don't have conventional metrics, as there are no extra points for headcount, budget size, or fixed expenses. We still don't care about press or the prestige of our office location. We did get some art this year as bare walls are depressing, but it was purchased on a shoestring budget and on Etsy, so at least we supported one of our companies. If you want to make the trek to Sherman Oaks, you can see a nice photo of Warren Buffett or the Memorial Coliseum (home of the Trojans) adorning the walls.

We keep our expenses low so we can pass on those savings to our clients. By charging less than most competitors (dramatically so in some instances) and offering what we believe to be a much higher value proposition, we think we create a virtuous cycle where we can build long term relationships with all our clients. Nick Sleep, a brilliant investor, calls this model "shared economies scaled." Amazon and Costco do this, and while we aren't exactly Fortune 50

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companies, we take the same principles that have worked so well for these fantastic businesses. If it worked for Carnegie, Vanderbilt, and Bezos, it should work for us too.

We focus on the inputs: how many annual reports we read, how many diligences calls we conduct, how many site visits we make, and how quickly we get back to our clients. Usually if you focus on the inputs, the outputs take care of themselves. Not that we worry about the growth of assets, but those grew pretty dramatically as well for yet another year. More importantly, the companies we own continued to execute on their goals (even if their share prices were down), and I am as confident as ever in their future prospects.

Most importantly, Davidson Kahn added two phenomenal new members to the team.

Drew Cohen is one of the first people I met at USC, on a bus on the way back from a Hillel retreat for Freshmen. He was in the row behind me, talking to some poor kid about why he had just bought Apple (he still owns those shares). We got off the bus, walked back to Birnkrant dorm and talked about investing for over an hour. We haven't stopped since. Drew comes from a more traditional Wall Street background, spending time at Goldman Sachs and Capital Group. The adjustment to our more austere offices must have been a shock, but one he took in stride. Drew is one the of the smartest and hardest working people I know, and I am excited to be working alongside him for decades to come. (He also doubled majored in accounting at USC, and as you all know, accounting knowledge is as important as it gets in my opinion).

Alex Lanzkowsky, CPA (the CPA is of course very important) joins us from Rockefeller Capital Management (who knows why these people would leave these prestigious jobs to work here)! Alex is also a graduate of USC and a sponge for learning and investing. He has a deep understanding of business operations, having helped lead a very successful medical business as its CFO, and is as hard working as they come. He too is incredibly bright and will over time be an excellent investor because of his natural aptitude and work ethic. He also has experience working in a more traditional wealth management environment, so he can distinguish what are the critical aspects of delivering the best possible service to our clients and what is fluff (we don't like fluff). His office is right next door to mine, which means we discuss the qualities of great businesses for hours on end, which is normal watercooler conversation I hear.

Right now, the team is small but is comprised of A+ players. We don't need a huge staff to achieve our mission of helping our clients grow and preserve their wealth. If more people come along at the talent level of Drew and Alex, we will do whatever it takes to have them join the team. We are in no rush to expand and could manage many multiples of the assets we do now with the team in place. I know this group will be successful because we are often the only cars in the parking lot at 8 AM on Saturdays and usually the only ones left at 6 PM.

I would be remiss if I didn't mention the actual MVP of Davidson Kahn, Berkshire Waldorf Davidson: an eighty-pound Bernese Mountain Dog puppy who calls 14011 Ventura Blvd home six days of the week. (I got to pick the first name, my wife got the middle name). Berkshire devours Annual Reports (literally devours them, I have the vet bills to prove it) and is a great addition to the office for his daily team building walks.

2022 was another year for the history books and I hope everyone can stay healthy and safe in 2023. 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 each 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.

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, if 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.

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