July 2020

"You cannot fight a good story just with facts."

– Yuval Noah Harari

For a brief period this spring public markets offered big sales on a wide variety of companies, commodities, and other assets. Oil prices got so low that I actually ran the math on storing oil in our swimming pool. I mentioned this to my wife, and she was able to deliver her response without saying a word. There is no oil in our swimming pool.

We reported in our April letter that we made six new investments in the first quarter. As you can see from the following commentary, our universe is not limited by geography, industry, size, or investment style. Markel (MKL) and Berkshire Hathaway (BRKB) – two of the highest quality companies in their respective peer groups – were offered at their cheapest multiples of book value in a decade. French water utility Suez (SZEVF) trades at a lower multiple and operates with far less leverage than the largest US water utilities. Wells Fargo (WFC) *grew* its book value through the financial crisis of 2008/2009, a rare feat among banks. Since then, its balance sheet has further strengthened and its book value per share has grown 2.5x, yet its share price has declined 20%. Regional sports network MSG Networks (MSGN), which owns the broadcast rights for the New York Knicks and Rangers, trades for a steep discount to last year's two major private market transactions for similar assets. And shares of Square (SQ), the small business payments platform, declined to 4x sales, a multiple we viewed as very reasonable considering its sales have doubled in just the last two years. Square is the latest example of our opportunistic approach to investing in high-growth companies, following on our investment in Mastercard (MA) in early 2016 after the collapse in oil prices pulled down gasoline prices, and our investments in the leading Chinese tech/consumer companies Alibaba (BABA), Tencent (TCEHY) and JD.com (JD) when their share prices declined during the 2018 bear market for Chinese stocks.

Collectively, we were able to buy shares in our newest portfolio additions at an average free cash flow yield of 11%, thanks to the S&P 500's 35% swoon from February to late March. Considering their 10% average 2019 revenue growth, the 11% cash flow yield should grow to mid- to high-teens over the next several years. We believe this represented excellent value in absolute terms, but especially relative to the 10-year Treasury bond's risk-free rate of 0.7%, which leaves investors with a negative return after inflation. Our more detailed investment summaries of each

new investment are provided in the following pages (all figures and commentary are as of the dates of our purchases). We made no new investments in the second quarter, although there are several companies we are closely monitoring as prospective additions to our portfolios.

We typically hold 20-25 investments in individual securities because, as we have said in the past, holding 50 or 100 investments would just dilute what we consider the best opportunities. We prioritize business quality and balance sheet strength, along with investing at discounts to intrinsic value. Buying the overall market exposes investors to stocks that don't meet these risk-mitigating criteria. We believe there are currently underlying economic risks that are not appropriately reflected in the market valuation. Following a period of unprecedented low interest rates, corporate leverage ratios are at all-time highs, putting those companies at risk if the economy further deteriorates. Equally alarming, large growth companies that are heavily weighted in the stock indices are imprudently valued in the market. The stories behind these popular stocks are obscuring the fact that exorbitant earnings multiples have periodically killed returns for even great companies throughout history. The commonality across these stocks is the widespread belief of their infallibility. We believe the better opportunities in the market now are in the mis-priced securities on the other end of that spectrum. AQR's Cliff Asness noted recently that the valuation spread between the market's most expensive and least expensive stocks has never been wider. The narrative around the modern-day "nifty-fifty" stocks is diverting attention away from other corners of the market that offer bargains as attractive as any we've seen in our careers.

New Investments

Markel (MKL)

Markel is a property and casualty insurance company based in Richmond, Virginia. The company has a well-earned reputation for quality under the leadership of the Markel family, who have long focused on specialty lines of insurance, where competition is based less on price because of the unconventional nature of the insured risks. Examples of the company's specialty lines include classic cars, yachts, fine art, museums, specialty event protection, pet health, terrorism risks, wineries, youth camps, zoos, and fishing charters. Insurers receive cash up front for the risk they bear, and claims are paid out at some point in the future. The resulting "float" is invested by the insurance companies, the returns on which are theirs to keep. Because insurance float alone generates returns, many insurers are willing to underwrite unprofitable insurance and rely on investment returns for overall profits. But Markel's insurance operations are a profit center. While the industry has generated a breakeven 100% combined ratio over the last ten years, Markel's average 96% combined ratio has earned it four points of profit before its return on investments.

Co-CEO Tom Gayner has managed the company's float for many years, and is a well-respected investor in the value investing community. Equities account for 40% of Markel's total investments, more in the mold of Berkshire Hathaway than the typical insurance company that

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invests the vast majority of insurance premiums in fixed income securities. Markel's equity weighting is not the result of a risky allocation. It has doubled over the last 15 years due to the cumulative effects of sensible stock investments.

Markel uses its balance sheet conservatively, as net written premiums are just 90% of policyholders' surplus, well below the 300% regulatory limit. Markel's creed of conservatism is a shock-absorber for exogenous events, as was the case when the company maintained book value growth when its combined ratio spiked to 124% after the 2001 terrorist attacks.

In 2005, the company launched Markel Ventures to buy controlling stakes in a diverse set of product and service businesses that are unrelated to insurance. From a cumulative net investment of approximately $1 billion, Markel Ventures' 2019 revenue and EBITDA increased to $2.1 billion and $264 million, respectively. It provides the company with a growing stream of diversified cash flow that strengthens the group and can be reallocated to still more investments.

Returns on the investment portfolio, together with the profitable insurance business and Markel Ventures, have combined to produce 11% compounded annual growth in per-share book value over the last decade. The company's approach and results have earned it favor with investors. The shares, which have historically traded for an average of 1.4x book value, have declined materially in the current bear market and are now available at a slight discount to book value. We view Markel as an ideal "anchor tenant" for a long-term investment portfolio.

Square (SQ)

Square provides payment hardware and software, primarily to small businesses, that interfaces with credit card networks and issuing banks. The company was founded in 2009 by Jack Dorsey and Jim McKelvey. Dorsey is CEO of both Square and Twitter. McKelvey was a glassblowing hobbyist who found it difficult to sell his glass faucets online because, as a small entrepreneur, he could not qualify for a traditional merchant account that would enable him to allow payment with credit cards.

Of the 30 million small businesses in the US at the time of Square's inception, only about six million accepted credit cards. Square's cloud-based point of sale opened the payments market to small merchants, and it delivered an excellent user experience as well as effective fraud prevention. Similar to Walmart's early decision to compete with small town general stores rather than go head to head with Sears, Square avoided direct competition with incumbents in the payments processing market, such as First Data.

Once Square had established itself serving small merchants, it landed a partnership with Starbucks. While that deal was unprofitable and ultimately abandoned, it propelled Square to upgrade its offering to enterprise class. No longer simply a payments system, Square developed a suite of tools to help merchants run their businesses, including inventory management, payroll, employee timesheets, and appointment booking. Square also provides access to capital through

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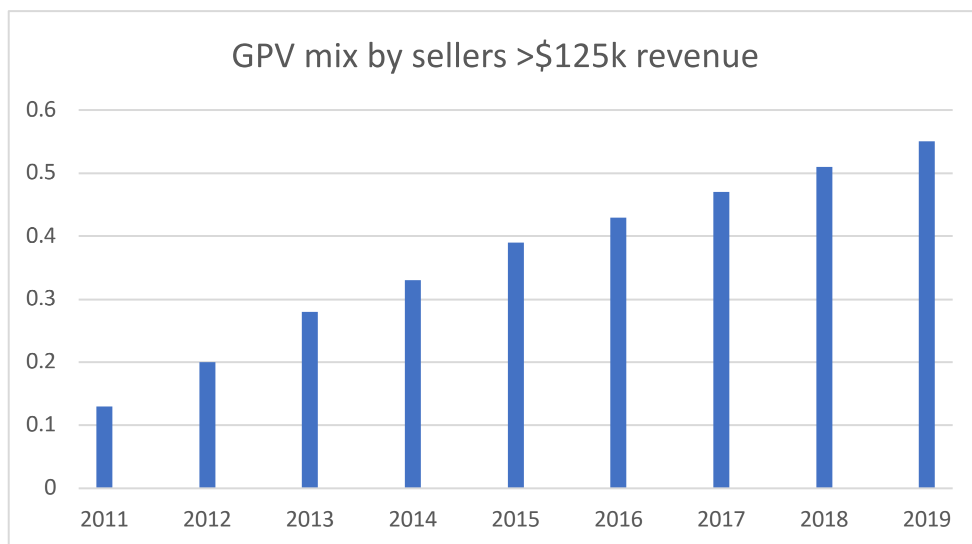
small loans as well as through Square Card, a business debit card that enables sellers to use funds instantly upon making a sale. Square Payroll targets small business owners that are underserved by payroll providers, and that often manage payroll manually. About one-third of Square Payroll sellers that joined in 2018 were new to Square, so Payroll is also a useful customer acquisition channel.

Square's seller payback period is three to four quarters on the sales and marketing spend to acquire customers. In a particular cohort, the customers they lose are offset by growth in customers they keep. Because net churn is zero, investments to acquire new customers create a predictable stream of revenue. In the same way that Apple captures customers with the iPhone and further leverages those relationships through high-margin services, Square locks in customers with its payments offering, and can amplify the value of those relationships through its tangential service offerings. The company is in the early innings of these other services, some of which are monetized through fees, such as interchange fees earned when sellers make purchases with Square Card. However, these services are mostly monetized by driving increased success among its customers, which in turn drives increased transaction revenues. In a virtuous cycle, Square's services help its customers succeed, and its successful customers tend to use more of Square's services. As shown in the following chart, this strategy's effectiveness is evident in the increased mix of payment volume from larger sellers.



Source: Square Inc 10-K filings.

Square's Cash App provides tools for individuals to send, spend, and invest cash. Monthly active customers have more than tripled in the last two years to 24 million at December 2019. Cash App had $676 million of stored customer balances compared to $22 billion for PayPal. Customers can also buy stocks, ETFs and bitcoin through Cash App. Bitcoin revenues more than doubled year-over-year to $516 million in 2019. Bitcoin margins are essentially a modest transaction fee; Square takes no Bitcoin inventory risk. We view this as low-risk exposure to the potential secular growth of blockchain technology and digital currency.

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Square's $4.7 billion of 2019 revenue represented 43% growth over the prior year, helped by 25% growth in gross payment volume to $106 billion. While revenue growth will fluctuate with the economic cycle, usage of the platform is very likely to grow over time. With a robust ecosystem that generated $400 million of free cash flow in 2019, and a strong balance sheet with $600 million of net cash, existential risk is low. Assuming a decelerating revenue growth rate to 15% over the next five years, revenues will triple. If Square can eventually earn a 20% operating margin – on par with First Data – then the current market cap is 8.5x estimated pre-tax 2025 earnings. A business with double digit growth of highly recurring revenues and ample cash flow would justify twice that multiple. These assumptions are obviously imprecise, but the broader point is that the business is likely to eventually grow beyond what is reflected in the current share price. While it is impossible to know how low the share price may go in the current bear market, the attractiveness of the investment will only increase at lower prices.

Suez (SEV.PA)

Suez is one of the world's largest independent water treatment and waste management utilities. It is Europe's second largest provider of water, and the largest in Spain. In waste, it also holds the second largest share of the overall European market, and is the largest in France. Suez was spun off from French gas and electric utility Engie in 2008. Engie continues to own 32% of the shares, and holds one-third of the board seats. Due to statutory age limits, chairman Gerard Mestrallet will retire this year, and CEO Jean-Louis Chaussade will become chairman. The board has appointed Bertrand Camus as CEO, effective May 14th. Camus is a 25-year veteran of Suez, and has headed the company's water businesses in North America and France, and was most recently in charge of the company's overall businesses in Africa, Australia, Asia, the Middle East, and India.

Suez operates 1,417 drinking water production plants, 2,701 wastewater treatment sites, 101 composting platforms, 47 incineration sites, 109 landfills, and collects waste for 33 million people. In 2018, Suez generated 7.7 terawatt hours of renewable energy, enough to power about two millions European households. Although waste and water are not high growth businesses, demand for these services should exhibit steady growth. For example, the World Bank estimates that the global urban population will increase by 1 billion over the next 20 years, and will drive increased demand for water infrastructure. The World Economic Forum estimates $26 trillion of needed spending on water infrastructure by 2030. Waste and water services are also recession proof; Suez revenue and EBITDA declined 1% and 2%, respectively, in the 2009 recession. Suez has decreased its reliance on the sluggish European economy from 80% of revenues in 2007 to 61% in 2018. It has increased its exposure to higher growth markets in North America, South America, Asia, Oceania, and Africa.

In 2010, Paris did not renew the management contracts held since 1985 by Suez and Veolia to operate the city's drinking water system. Instead, Paris created a government-owned company to run the system. This triggered more re-municipalization cases in France and elsewhere in Europe, and is a headwind for Suez.

Consistent with the disparity in global stock market valuations, Suez trades for 5.2x enterprise value to 2018 EBITDA, compared to 16.x and 18x for American Water Works (AWK) and Essential Utilities (WTRG), the two largest US water utilities. The multiple premium partly reflects higher leverage ratios (net debt / EBITDA) of 5.0x for AWK and 5.4x for WTRG (before a recent equity raise) compared to 3.2x for Suez. Compared to Suez, which generates ample operating cash flow that funds both capex and dividends, operating cash flow for the two US utilities does not cover capex. Dividends for AWK and WTR are effectively financed, and yield 1.7% and 2.8%, respectively.

Suez trades for a dividend yield of 4.5%, and the business is growing 3-4% annually, for a baseline annual shareholder return of about 8%. It seems reasonable to expect the multiple of EBITDA to rise over time as water and waste services become ever more important to support a growing global population with limited resources.

MSG Networks (MSGN)

MSG Networks owns and operates two regional sports networks (RSNs), MSG Network and MSG+. The company was spun out of The Madison Square Garden Company (MSG) in 2015. MSGN is the oldest RSN, dating to 1969. Its primary assets are the exclusive live broadcast rights, through long-term agreements with the NBA and NHL, for the New York Knicks, New York Rangers, New York Islanders, Buffalo Sabers, and New Jersey Devils. It also has partial coverage of the New York Giants and Buffalo Bills of the NFL. Its two most valuable agreements, for the Knicks and Rangers, each have remaining terms of 15 years. The company airs more than 450 live professional games each year, as well as pre- and post-game coverage featuring coaches and players.

The networks are distributed throughout the states of New York, New Jersey, and Connecticut, as well as parts of Pennsylvania, by Charter, Altice USA (formerly Cablevision), Verizon, AT&T, and through MSG GO, the company’s streaming service. MSGN has multi-year carriage agreements with each distributor that generate affiliate fees, which account for 90% of the company’s revenues. The remainder of revenues are generated from the sale of advertising inventory that is aired on its programming.

With a market cap of $700 million and an enterprise value of $1.6 billion, the shares trade for 4x free cash flow, or 9x including net debt. The shares are trading at their lowest level since the spin-off due to low-single digit annual cable subscriber losses, and due to the revenue-suppressing futility of the New York Knicks, which has the fifth worst record in the NBA, and are about as bad as they’ve been in 50 years. James Dolan, who is chairman of MSG and MSG Networks, is not a popular figure in New York. The Dolan family owns 25% of MSGN and controls it through super-voting stock. The shares declined further after the recent decisions by the NBA and NHL to suspend their seasons due to the coronavirus.

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All that said, several factors lead us to believe the bears are wrong. First, the company typically has a carriage agreement come up for renewal each year, and on the February earnings conference call management discussed renewals as including rate increases. That included the first renewal agreement with Altice USA since it acquired the Dolan-controlled Cablevision, which is a major MSGN distribution partner. Having affirmation of the value of MSGN's content from a truly independent entity is key. Second, MSGN can change with the industry. While the company has not announced any major distribution agreements with streaming platforms, management says they are in discussions with YouTube and Hulu, among others. Third, if the Knicks improve, either through high draft picks (which they will receive because of their poor league standing) or through improved management and coaching, the network's ratings and advertising revenue will increase. Fourth, since the US Supreme Court struck down the federal ban on sports betting in 2018, looser state restrictions have spread across the country. Currently, sports betting is legal in 12 states, and six other states and DC have passed bills to legalize it. Sports betting is legal in New York, but in very limited areas, leading to the vast majority of revenues being lost to New Jersey. Fewer restrictions by the state of New York would lead to higher ratings and advertising revenue for MSGN.

Recent private market transactions imply that MSGN's shares are not being properly valued in the stock market. As part of its 2019 acquisition of certain Fox assets, Disney received 22 RSNs that it was mandated to sell for antitrust compliance. In March 2019, Disney sold The Yankee Entertainment & Sports Network (YES) for $3.5 billion to a group that included Yankee Global Enterprises, Blackstone Group, Sinclair Broadcast Group and Amazon. The interest from financial and strategic buyers is notable and speaks to the importance of live sports at a time of cable subscriber losses. Amazon plans to distribute broadcasts via its streaming service. YES Network's annualized EBITDA at the time of the deal was reported to be about $400 million, implying an enterprise value and per share value for MSGN of $2.6 billion and $27, respectively.

Disney sold the other 21 RSNs for $10.6 billion, or 2.8x revenue, to Sinclair Broadcast Group. The RSNs included Fox Sports Arizona, Fox Sports Detroit, Fox Sports Wisconsin, Fox Sports Indiana, Fox Sports Florida, Fox Sports Carolina, and Fox Sports Kansas City. Applying the deal's revenue multiple implies a share value of $16.25 for MSGN. I believe that sets a floor because New York is a more attractive market as the country's largest MSA, and because MSGN has optionality on improved results, as laid out above. Supporting this view is the fact that smaller market NBA franchises in Memphis, Milwaukee, Sacramento, and New Orleans all sold in the $300-$600 million range between 2012 and 2014. In comparison, the Los Angeles Clippers sold for $2 billion in 2014, the Houston Rockets sold for $2.2 billion in 2017, and the Brooklyn Nets sold for $3.5 billion in 2019. Forbes estimates the value of the New York Knicks at $4.6 billion, equal to the estimated value of the New York Yankees. Underscoring the franchise value, average ticket prices for the Knicks are the highest in the NBA, and twice the league average.

Assuming status quo, we believe the company will continue to generate free cash flow at least for the next several years consistent with the $179-$207 million range of the last four years because of the multi-year and staggered nature of its various contracts. What really piqued our interest was the company's October 2019 repurchase of 24% of the shares at $16.70 in a tender

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offer. While the shares are now about 30% lower than the tender offer, the market cap is 40% lower. The board appears to be in favor of continued repurchases, and the company has $186 million remaining on its share buyback authorization. In theory, aggregate free cash flow over the next three years could fund the repurchase of half of the company's remaining shares at the current price.

Wells Fargo (WFC)

The regulatory framework for banks known as Basel III, agreed upon in 2010, more than doubled the percentage of common equity banks were to hold against risk-weighted assets, as compared to the previous standard that was in place prior to the 2008 financial crisis. The Basel III standard has been implemented in stages over the better part of the last decade. In other words, banks are now twice as well capitalized as before 2008, yet bank stocks now trade for far lower multiples of earnings or book value than they did when they were riskier.

The current equity bear market has led an investor rush to safety, driving the price of Treasury bonds higher, and the yield lower. The yield on the 10-year Treasury has fallen below 1%. The stock market exodus lifted the effective yield of shares. Wells Fargo's earnings yield of over 14% compares to 5.2% for US high yield corporate bonds, and 2.9% for US investment grade corporate bonds. Unlike bonds, Wells Fargo's retained earnings lead to per-share earnings and book value growth over time. That's a key advantage over fixed-rate bond interest payments.

Wells Fargo is the fourth largest bank in the US, with a well-earned reputation for quality. From 2007-2009, the most difficult financial period in decades claimed many casualties among companies in the banking, mortgage, and housing industries. Wells Fargo never lost money despite being nearly twice as levered then as now. Its book value was preserved through that period.

More recently, its reputation was muddied when it came to light in 2016 that the bank had fostered a culture of illicit growth. Since 2002, bank executives had ignored employees fraudulently opening fake accounts in order to earn incentive bonuses. More than $4 billion of penalties have been levied against the bank, and regulators have capped its assets since 2018. The company has already reserved against those penalties, so there will be no impact to earnings this year. The stock's earnings multiple has declined to 6x, down from 17x before news of the scandal broke. But Wells is much stronger financially than it was in 2008. It carries nearly twice as much equity capital per risk-weighted dollar of assets as it did before the financial crisis. Even with today's compressed interest-rate spreads, the bank generates a respectable 10% return on equity.

In September 2019, Wells Fargo named Charlie Scharf as CEO. For the first 25 years of his career, he worked for Jamie Dimon at Citigroup, Bank One, and then JP Morgan, where Dimon has been the long-time CEO. Scharf ran JP Morgan's retail bank until being hired in 2012 as CEO of Visa, the world's largest payments company. Five years later he was named CEO of BNY Mellon, the

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world's largest custodian bank. Clearly, he has the proper credentials to lead Wells Fargo, but his biggest asset may be his directness in acknowledging the bank's reprehensible mistakes. That approach should enable the company to address its deficiencies and move forward.

There's more work for Scharf aside from correcting for the fake-account scandal. The bank's efficiency ratio of 68% in 2019 is about ten percentage points worse than its historical level, suggesting potential for cost improvements of $8.5 billion, or $1.50 per share after-tax. That implies normalized earnings of $6/share. In time, we believe the Federal Reserve will lift the cap on Wells Fargo's assets, leading to a resumption of growth. As the current scandal fades and the bank's efficiency improves, the multiple on its shares should rise.

Berkshire Hathaway (BRKB)

Berkshire Hathaway is a conglomerate controlled by Warren Buffett. It owns a diverse collection of leading businesses in the insurance, industrial, consumer, real estate, energy, and utility industries. Its portfolio of operating businesses includes Geico, General Reinsurance Corporation, BNSF Railway, MidAmerican Energy Company, Precision Castparts, Shaw Industries Group, Benjamin Moore, Duracell Company, International Dairy Queen, Clayton Homes, and many others. Collectively, its businesses generate on average $25 billion of annual free cash flow, which is redeployed by Buffett and his long-time partner, Charlie Munger. Free cash flow has grown 11% annually since 2010. Investment of the cash flow has led to 16% annualized growth in its cash and equities portfolio. Combining the two components, intrinsic value has grown 14% annually.

A 15x multiple of free cash flow conservatively values the operating businesses at $375 billion. Its portfolio of stocks has a current mark-to-market value of $150 billion, down from $242 billion at the end of 2019. Excess cash is $125 billion. The three components sum to $650 billion. After declining 30% in late March, the market cap of $395 billion represented a 40% discount to the sum-of-the-parts (SOTP) value. We view this SOTP value as a discount to intrinsic value for three reasons: 1) stock prices are depressed, especially those of bank stocks, which represent one-third of Berkshire's portfolio; 2) depressed market values offer Buffett an opportunity to deploy the company's excess cash at high expected rates of return; 3) economic strain and low interest rates caused by the coronavirus pandemic will deplete capital from the insurance industry and could lead to firmer insurance rates, which would be a boon to one of Berkshire's core businesses.

The biggest perceived risk is the fact that Buffett is 89 and Munger is 96. It is true that this duo is irreplaceable. However, given the quality of the businesses they have assembled, it would take severe mismanagement to destroy value, and that simply won't be the case. Berkshire Hathaway has a bench of senior executives that have provided steady leadership of their respective divisions for many years. Greg Abel oversees all of Berkshire's non-insurance businesses, and Ajit Jain is in charge of the company's insurance operations. For the first time, Abel will participate in the question and answer session at this year's annual meeting. On the investment side of the business, Buffett in 2011/2012 hired Todd Combs and Ted Weschler, who each oversee about

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$14 billion portfolios. It is clear that Buffett has taken great care to select competent, ethical people and he has immersed them in the company's culture that has been so important to its success. We anticipate minimal disruption when management eventually changes hands.

Important Disclosures:

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Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be profitable. The New Investments section describes each new security in which we initiated a position during the referenced six-month period. Every security may not have been purchased for each client based on the timing of a particular account opening, or based on assessed needs of a particular account.

Past performance may not be indicative of future results. Therefore, no current or prospective client should assume that the future performance of any specific investment or investment strategy (including the investments and/or investment strategies recommended by the adviser) will be profitable or equal to past performance levels.

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