Portfolio Activity Q3 2018

By Louis S. Foxwell, Research Analyst

The following discussion mentions stocks that are widely — but not universally — held by clients of Horan Capital Management. Client portfolios are customized, so this commentary may or may not be directly applicable to any given client or account. Our intention is to provide general insight into portfolio holdings and into our overall approach and to highlight situations of interest, both positive and negative. The mention of any stock is neither advice nor a solicitation to buy or sell any particular investment and our opinions regarding securities are subject to change without notice. Investing involves risk of loss. See the legal disclosures at the end of this publication and on our website for more information.

BUYS

Booking Holdings Inc. (BKNG)

Booking Holdings (formerly known as Priceline) operates as an Online Travel Agency ("OTA"). The company's online platforms facilitate business transactions between travelers and hotels/airlines/rental car services. In most cases, Booking acts as a platform and receives a commission for lending its network to travelers and businesses. In other cases, Booking will act as the facilitator of payments, buying rooms in bulk and selling them individually at a profit. The company also generates advertising revenue on select platforms.

Most of Booking's revenue is generated in Europe where boutique hotels are commonplace and there is very little consolidation in the hotel industry. This lack of consolidation makes smaller hotels dependent on Booking's services, giving the company a wide economic moat. The company has a pristine balance sheet, with net cash and investments. A majority of the company's gross profit comes from commissions, giving Booking a toll booth-like business model and substantial cash flow. Management has consistently demonstrated the ability to reinvest this cash effectively with incredible foresight into growing markets. We purchased shares during the quarter as they traded below our estimated intrinsic value.

The Charles Schwab Corporation (SCHW)

The Charles Schwab Corporation provides financial services to individual investors, independent investment managers, retirement plans, and institutions. These services include securities brokerage, banking, fund options, and advice solutions. Charles Schwab offers numerous financial services, but its most profitable line of business is banking. It makes net interest revenue on the spread between what it pays depositors and what it receives in interest income. The company also generates business from (1) money market funds, (2) mutual fund and ETF service fees, (3) brokerage and asset management services, and (4) trading revenues.

Schwab sweeps cash balances into two different places: money market funds and bank subsidiaries. Over time, Schwab has been able to gradually sweep more into its banks. This is a good thing for shareholders, because the company generates more money from bank sweeps than from money market sweeps. Cash balances as a percentage of client assets are at an all-time low right now. As these cash balances increase and Schwab continues to sweep more of that cash into its bank subsidiaries, the company's profitability should increase. We believe that this would offset any decline in total client wealth and its potentially negative effect on net revenue. There is some concern in the market that trading revenue will decline as the company lowers its fees. Fortunately, Schwab is in a position where it can be the loss leader in this space. In effect, the company can subsidize this portion of the business with other segments. This is where the company

BUYS (Cont'd)

thrives. It is able to spread costs over all business segments and create somewhat of a network effect within its ecosystem. After doing a deeper dive, "normalizing" the earning power of the business, and weighing the various factors that contribute to revenue generation, we saw a mispricing in the market and an underappreciation of the business. We view this as a potential long-term core holding for clients.

Tencent Holdings Ltd. (TCEHY)

Tencent is an investment holding company. It invests in numerous businesses in a diverse range of industries. These industries include video games, payments, ride sharing, advertising and social media, banking, video and music streaming, and retail (among others). The company's largest revenue source is online gaming. Other sources include (but are not limited to) subscription revenue from music and video streaming, advertising revenue, and fees from payment services.

Tencent is the largest online gaming company in the world. Online gaming is very lucrative because (1) it is easily accessible and therefore played more frequently, and (2) it enables in-game purchases. These in-game purchases consist of virtual items like clothes, maps, and general customizations. The incremental cost of these virtual items is essentially zero to the company, so every new item sold past initial development cost falls to the bottom line. This business model creates a recurring stream of cash flows with very high returns on investment. Despite gaming being the company's largest revenue source, we believe that the company's most valuable asset is WeChat – a smartphone application that offers a broad array of services to its users. The WeChat platform enables messaging, social networking, work groups, mobile payments, online shopping, payments at stores, a ride-hailing service, food ordering, sending money to friends, and buying event tickets. All of this is done on the WeChat app, creating a valuable and convenient ecosystem for the user. This app has over one billion monthly active users who each spend an average of over an hour each day using it. Our underlying thesis on the company is that Tencent has not fully monetized these user hours and has a clear path to do so in the future.

The negative factors that have punished Tencent's share price of late have all been outside of the company's control. For example, China has banned new game releases and ramped up age restrictions on games due to an increase in gaming addiction in the country. If the gaming ban is lifted, for example (and we believe it ultimately will be), then this could represent a coiled spring for the company. Furthermore, while other macroeconomic factors like the trade war are certainly legitimate, we believe that they are baked into the current share price. Therefore, we entered the position at a price which we believe compensates us for any inherent risks.

Alphabet, Inc. Cl. C (GOOG)

Alphabet (formerly known as "Google") continues to dominate and grow through its wide economic moat. Alphabet is highly profitable, has minimal debt, and holds a stockpile of cash on its balance sheet. These attributes, coupled with an underappreciation of the company's network effect, an opportunity to significantly monetize YouTube, and an over-penalization of Google Ventures' negative profitability, continuously incentivize us to add to our long-term position when given the opportunity. We also believe that shares of Alphabet were punished during the quarter as a result of a broader punishment of larger "tech" stocks and increased scrutiny pertaining to data protection. We were able to acquire more shares of this high quality company at prices which we believed compensated us for these risks.

Berkshire Hathaway Inc. Class B (BRK.B)

Berkshire Hathaway is a holding company that owns subsidiaries in a diverse range of industries – from railroads and insurance to batteries and candy. It is run by legendary investor and businessman Warren Buffett. We purchased shares of Berkshire Hathaway throughout the quarter as the stock traded below our estimation of intrinsic value.

BUYS (Cont'd)

Facebook, Inc. (FB)

Facebook, Inc. owns multiple social networking platforms – most notably Facebook, Instagram, WhatsApp, and Facebook Messenger. Facebook generates revenue by selling advertising space on these platforms to businesses around the world. We continued to add to this position during Q3, as we believed that shares were materially undervalued and that nothing fundamentally had changed with the company's business model. In our opinion, Facebook's economic moat is very wide due to a lack of competition and a strong network-effect. Pessimism in the market surrounds concerns over decelerating growth and slimmer margins. This pessimism, however, fails to consider the entire picture. Firstly, despite decelerating growth, the company remains one of the fastest growing companies in our portfolio. Secondly, one notable culprit for slimmer margins is discretionary spending on growth. This spending is a form of long-term investment, which we like, but the market continues to penalize it. Therefore, we were pleased with the opportunity to purchase shares at a discount to our estimated intrinsic value.

Starbucks Corporation (SBUX)

Starbucks retails specialty coffee around the world. It primarily operates retail locations but sells whole bean coffees and bottled drinks outside of its retail locations as well. We added shares of Starbucks to client portfolios because it checked all of our boxes for a high-quality business selling at what we believed to be a fair price. In our opinion, the company's greatest asset is its brand. We see tremendous value in the fact that it has captured significant mind share among millions of global consumers and has become a staple in many people's daily routines. We believe that this gives the company excellent pricing power and limits its customer acquisition costs.

Wells Fargo & Company (WFC)

Wells Fargo is the third largest bank, by assets, in the United States. We purchased shares during the quarter as the company continued to recover from negative sentiment.

SELLS

(The positions below were eliminated in most accounts. In some cases, positions were kept in selected client accounts for tax purposes.)

Biogen Inc. (BIIB)

We sold shares of Biogen in all accounts except for those with short-term taxable gains. We believed that Biogen had reached its fair value range, and we saw better opportunities in the companies listed in the "Buys" section.

Bristol-Myers Squibb Company (BMY)

We sold shares of Bristol-Myers in all accounts except those which had short-term taxable gains. We made the sale because the stock price had reached our fair value and we believed that there were better opportunities in the market.

SELLS (Cont'd)

Chipotle Mexican Grill, Inc. (CMG)

Shares of Chipotle have performed very well since our most recent purchase of the stock. This led to many overweight positions in client accounts, which we trimmed and reallocated to more attractively valued opportunities.

General Electric Company (GE)

We still feel the stock is undervalued based on a sum-of-the-parts analysis; however, we believe that it may take some time for a recovery due to ongoing restructuring efforts. We sold shares of GE in specific taxable accounts in order to offset some taxable gains and we subsequently used those proceeds for more attractive opportunities.

Gilead Sciences, Inc. (GILD)

We sold all shares of Gilead as we felt that there were better opportunities elsewhere.

Nike, Inc. (NKE)

We trimmed the position during the quarter for valuation and portfolio weighting purposes. We used the proceeds for the opportunities described in the "Buys" section.

Union Pacific Corporation (UNP)

We trimmed UNP as we felt shares had appreciated to a fair value range and the position became materially overweight in client accounts. We continue to view this position as a core long-term holding.

Qualcomm Incorporated (QCOM)

We sold shares of Qualcomm during the quarter due to three factors: full valuation, the presence of other opportunities, and uncertainty regarding the value of its Intellectual Property. As per usual, we conducted the sale with tax considerations in mind and redeployed the proceeds into other opportunities.