Wedgewood Partners First Quarter 2024 Client Letter

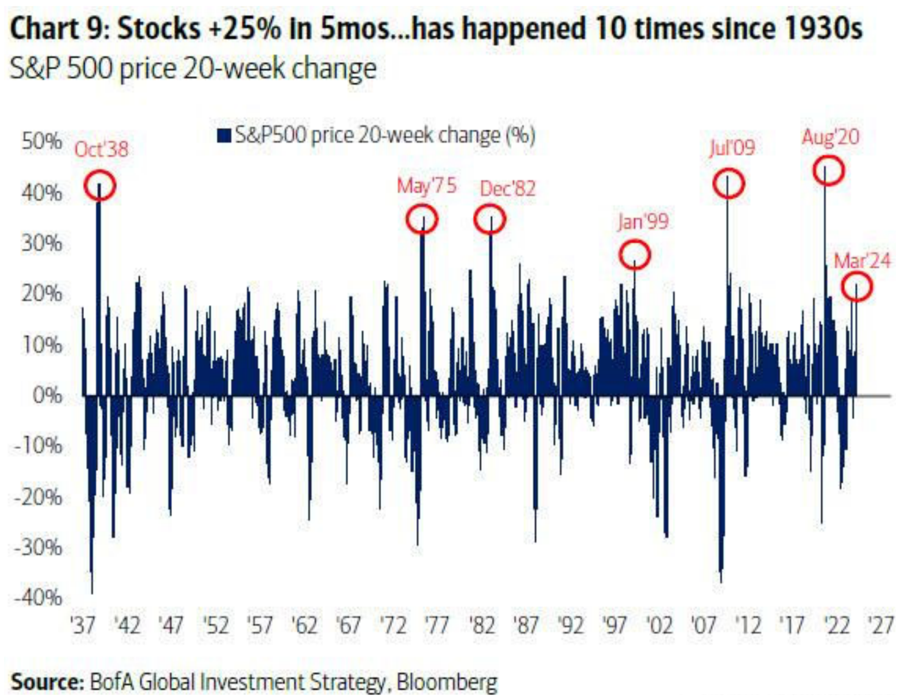
<u>The</u> <u>Magnificent</u> <u>Roaring</u> <u>‘20’s</u>

“It’s a bull market, you know.”

Jesse Livermore. ***Reminiscences of a Stock Operator.***

“The job of sustainably restoring 2 percent inflation is not yet done…the higher inflation data over January and February were above the low readings in the second half of last year…We do not expect that it will be appropriate to lower our policy rate until we have greater confidence that inflation is moving sustainably down toward 2 percent.”

Jerome Powell. Chairman Federal Reserve Board.



	1Q	YTD	1-Year	3-Year	5-Year
Wedgewood Composite Net	11.5	11.5	31.1	10.7	16.6
Standard & Poor's 500 Index	10.6	10.6	29.9	11.5	15.1
Russell 1000 Growth Index	11.4	11.4	39.0	12.5	18.5
Russell 1000 Value Index	9.0	9.0	20.3	8.1	10.3
	10-Year	**15-Year**	**20-Year**	**25-Year**	**30-Year**
Wedgewood Composite Net	11.6	15.8	10.5	9.3	12.9
Standard & Poor's 500 Index	13.0	15.6	10.2	7.8	10.7
Russell 1000 Growth Index	16.0	17.9	11.9	8.0	11.2
Russell 1000 Value Index	9.0	13.1	8.3	7.4	9.8[i]

Top performance contributors for the first quarter include Meta Platforms, Taiwan Semiconductor Manufacturing, Tractor Supply, Edwards Lifesciences and Copart.

Top performance detractors for the fourth quarter include Apple, UnitedHealth, S&P Global, Booking Holdings and Tractor Supply Company.

During the quarter, we trimmed Meta Platforms twice because it breached our maximum position limit weighting of 10%. We increased UnitedHealth.

Q1 Top Contributors	Avg. Wgt.	Contribution to Return
Meta Platforms	8.86	3.18
Taiwan Semiconductor Manufacturing	6.47	1.79
Tractor Supply	4.94	1.08
Edwards Lifesciences	4.14	1.01
Copart	5.92	1.01

Q1 Bottom Contributors		
Apple	7.09	-0.84
UnitedHealth	5.76	-0.28
S&P Global	2.29	-0.07
Booking Holdings	4.58	0.11
Texas Pacific Land	1.55	0.11[1]

[1] Portfolio contribution calculated gross of fees. Contribution to return calculations are preliminary. The holdings identified do not represent all of the securities purchased, sold, or recommended. Returns are

A few of our best and worst relative performers during the first quarter were the same as last year's fourth quarter.

The following summaries are a few stocks we have not discussed of late.

CDW was a positive relative performer. The Company generated nearly flat gross profit growth in 2023 off difficult 2022 (+31%) comparisons (partially from M&A). The Company has done a remarkable job helping its small and medium-sized customers shift from hardware-centric IT layouts to hybrid and software-based implementations. CDW's core customer typically has constraints in both IT department staffing and related resources, making it difficult for large enterprise-focused IT vendors to reach those customers. As a result, there are plenty of proven technologies that have been adopted by larger businesses, often long ago, that will eventually find their way into small and medium-sized businesses with the help of CDW. CDW is agnostic to the consumption models or form factors of technologies, which is why the Company has been able to maintain superior returns over many different technology cycles and innovation trends. We think helping small and medium-sized businesses setup and run their IT departments is more important than any specific technology that happens to enable those departments and should help the Company continue to grow and take share of IT budgets over time.

Copart was a top contributor to performance during the first quarter. First quarter gross margin dollars grew +9% and earnings per share grew +11% as the Company's salvage vehicle auctions processed more volume, driven by skyrocketing vehicle repair costs in the U.S. and strong demand for salvage vehicles in emerging markets. The pullback in vehicle total-loss frequency that began during the pandemic has reversed. We expect another multiyear run ahead as repair costs inexorably rise along with vehicle complexity. In addition, Copart's key insurance carrier customers are always looking to maximize recoveries from vehicle losses, and the Company has done an excellent and growingly efficient job developing a significant market for these totaled vehicles by finding a growing list of buyers in developing markets.

Booking Holdings contributed negatively to relative performance. The Company grew bookings on their platforms +16% and reported +22% growth in adjusted operating income during their fourth quarter of 2023. We think the market is cautious about the Company's results for 2024 because they will be lapping very high levels of growth compared to those in 2023 (full year 2023 bookings growth +24%). However, Booking's end markets continue to be quite healthy, outside of geographies affected by war because consumers still have plenty of wallet share to re-dedicate to travel compared to pre-COVID-19 numbers. We applaud the Company as they aggressively repurchase shares at valuation levels well below the market and peers. This should serve to compound our ownership in Booking's business, which has exceptional profitability.

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presented net of fees and include the reinvestment of all income. "Net (actual)" returns are calculated using actual management fees and are reduced by all fees and transaction costs incurred. Past performance does not guarantee future results. Additional calculation information is available upon request.

Pool Corp's stock was flat during the first quarter. The Company reported sales in their last quarter that declined -8% due to mild weather earlier in the year and after a few years of elevated sales driven by COVID-19 dynamics. We view these declines as transient and are not reflective of longer-term industry competitive dynamics. The Company continues to take market share in the North American pool care business and has maintained excellent profit and return metrics during this post-Covid digestion period. Pool Corp differentiates itself by carrying a large array of industry-specific products compared to mass-market retailers that carry more standardized products or smaller industry competitors that have less availability or narrower selections. This sweet spot positions Pool Corp well in the expanding pool care and development market and the Company should be able to drive double-digit earnings growth over the next several years.

S&P Global contributed negatively to performance during the quarter. The Company grew organic revenues +11% in its last reported quarter as capital markets, especially for borrowing, are wide open for business. Even with a strong economy, the Federal Reserve is still signaling that they are ready and willing to cut rates, albeit at a slower pace than the one assumed just a few months ago. Having only recently recovered from a decade-long yield famine, fixed-income investors are becoming desperate once again, making concessions to issuers in order to lock in rates for fear they will not see these coupons for another generation. This hyper-financialization of the U.S. and global economy will continue for the foreseeable future and that S&P Global's pricing and capital formation services should continue to enable it.

Visa stock posted a small negative drop during the quarter. In the first quarter, the Company grew earnings per share +11% as payment volume growth was up +8% and cross-border payment grew a solid +16%, adjusted for currency. Beyond their consistent growth and execution, recent regulatory trends have caught considerable investor attention. The Company's networks and value-added services drive enough economic value to bank customers and retailers that the addressable market for payments should continue growing at a healthy rate for many more years, regardless of recent regulatory changes. Visa's value-added services can be extended to less-sophisticated, emerging non-Visa networks to help grow the overall payment ecosystem that make up the vast global payment addressable market. For example, not long after debit interchange rates were regulated last decade, Visa began an aggressive push to allow non-bank financial institutions access to Visa's networks, which helped drive more interchange volume to banks and offset lower interchange rates. This was a key element that spawned the massive "Fintech" industry that exists today. We continue to expect Visa's scale and breadth of service offerings will help them drive attractive growth at stellar margins along with the overall payments' ecosystem.

Company Commentaries

PayPal

PayPal has been a long-standing holding for Wedgewood, since 2015. After taking some of our gains around the company's COVID-19-fueled peak in 2021, we have been adding to the stock slowly over the past two years, taking it back to a significant position in the portfolio.

We would like to update you on our current thinking.

Like most "COVID-19 stocks", a variety of companies (e.g., Amazon) benefited from artificially high growth rates due to the COVID-19 lockdowns and subsequent stimulus; fundamentals at PayPal saw a normalization as the world returned to normal through 2021-2022. Similar to most of those companies, many PayPal investors had incorrectly assumed their artificially elevated growth rates during the COVID-19 period would continue for years and were surprised when the normalization occurred, leading to a decline in the Company's admittedly overheated stock. The big difference between PayPal and many of these stocks (e.g., Amazon once again) is that PayPal still has not recovered from this broad normalization period.

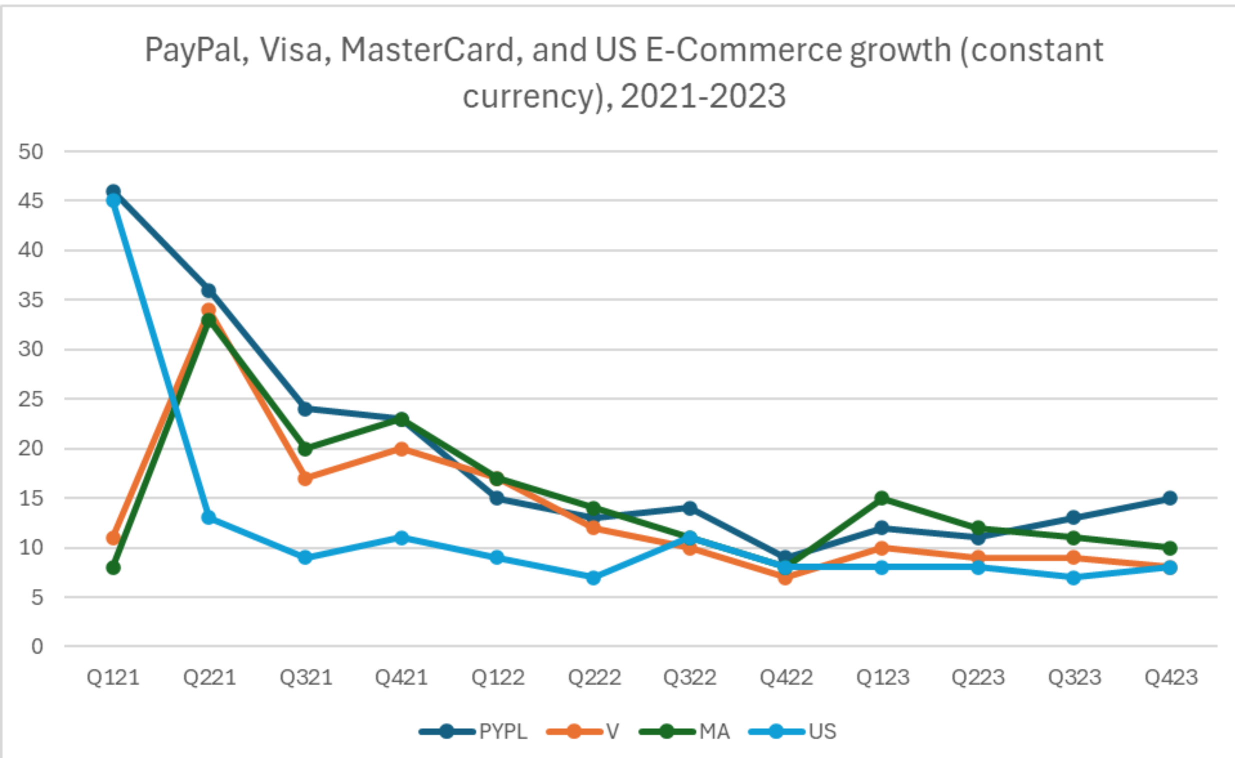
When fundamentals at a previously loved company take a negative turn - as happened with many of the COVID-19 stocks when artificially high growth rates were normalized – we generally see investors tend to look past the obvious culprit and do their best to uncover other problems that may not be problems at all. In this case, it seemed that a few bears could see the culprit that seemed rather clear to us - namely, the very rational normalization in growth rates after a period of wildly inflated growth. Certainly, we observed this phenomenon around the post-COVID-19 normalization, when not just at PayPal but at almost all the COVID-19 beneficiaries experienced a sharp decline. The impact of this event in the significant downturn in technology stocks as the market adjusts to a new normal.

In PayPal's case, the winding down of the company's long-standing relationship with eBay also coincided with this period of normalization, contributing a bit more to the bust side of the boom/bust cycle everyone else was experiencing. The eBay situation had been coming for years, as anyone paying attention should have known - still, the timing of the final closure of the compounded the already negative PayPal stock sentiment.

Investors then began to propose a variety of additional theories about what was going wrong. Many of these theories can be categorized under the broad heading of "share loss," where a variety of smaller payment platforms, digital wallets, ancillary service offerings all were (and still are) considered existential threats to PayPal.

Before the Federal Reserve's significant rate hiking program, the Buy Now Pay Later (BNPL) providers were one of the theoretical issues for PayPal, for example. Setting aside the questionable business case of borrowing money in order to lend it to consumers at zero percent - a business case that became even more questionable as the cost of borrowing rose significantly - there was plenty of noise around PayPal losing share to BNPL providers, because investors could see outsized growth rates from those providers, whereas PayPal's growth rates were relatively lower. Obviously, smaller companies with mathematically have an easier time showing faster growth rates than larger companies due to growing from a lower base. More to the point, this also doesn't mean the large companies have necessarily "lost share" in the industry, if they continue to grow along with the broad industry.

To track broad industry growth for PayPal, we follow the Company's total payment volume (TPV) growth in relation to Visa, MasterCard and broad U.S. e-commerce growth, among other things. As you can see in the chart below, PayPal routinely tracks at or near the top end of these broad industry trends, so arguments regarding share loss is puzzling to us.



Source: Company reports, U.S. Census Bureau

We need to emphasize too that one of the primary drivers of the investment case here is the payments market is still growing strong, and a large market growing at such rates has room for more than several players to succeed. A smaller player growing at a higher growth rate than PayPal means neither that PayPal is neither losing share, nor that PayPal is unable to continue as a successful business.

Another component of the negative sentiment around the Company was uncertainty around the leadership of the Company. Long-time CEO Dan Schulman and CFO John Rainey both announced their retirements during the post-COVID-19 deceleration period. The Company spent a significant amount of time finding their respective replacements. Further confusing matters, some investors (including us) had been fans of the company's management team and hoped the Company would name replacements who would continue the long-time strategy of growing profitably; others hoped to see more growth-oriented leadership (or, in our thinking, growth that does generate much bottom-line profitability, common enough in large-cap tech). The Company named a CFO replacement, Blake Jorgensen, who had medical issues and had to leave almost immediately after his arrival. Subsequently, the Company has appointed replacements for both major roles. Alex Chriss joined as CEO from Intuit toward the end of 2023 and Jamie Miller joined as CFO from Ernst & Young shortly afterward. Although it is obviously early in this new leadership team's tenure, everything we have been hearing from them leads us to believe they will continue the company's successful long-term strategy of building lasting profitable growth.

Although the negative commentary around the company has wandered from topic to topic, perhaps the most recent commentary has been some concern around the import of Company's declining profitability within their merchant services. We also agree this is one of the issues raised by the broad market on PayPal's current fundamentals that matters most. It definitely is true that the Company's margin on transactions has been declining over the past few years as it aggressively expanded its Braintree service, a payment platform for merchants that can accept almost all major forms of digital payments. While Braintree is unlikely ever to be more profitable than the company's flagship PayPal button on a transaction margin basis, its profitability has been artificially low while the company has expanded significantly, with the company sacrificing pricing to build a large beachhead of share in this service.

Notionally, we are not fans of companies sacrificing margins to grow; however, what sets PayPal apart is that the total company remained quite profitable as it pursued this aggressive growth in one side of the business. We also would note that Venmo is another growing service that is less profitable than the core PayPal branded business, and the market absolutely loved Venmo not so long ago.

We would be much more concerned with the Braintree growth, and its impact on total company profitability, if we expected the current growth rates and margins to continue into the many years ahead. However, the company has made it clear that it is at or near the end of the initial beachhead phase of its Braintree strategy. New CEO Alex Chriss has been addressing this topic specifically, saying they now have a solid position in the industry, they will be taking more normalized pricing, and they also will be expanding a variety of higher-margin ancillary services they can now roll out to their established customer base. We believe this will lead to improving transaction margins in the next several quarters and will begin to remove this particular concern for the market.

Overall, the overwhelmingly negative sentiment in the stock of late, has given us the opportunity to reload our position in the stock. We continue looking at the fundamentals: for example, the company reported +23% earnings per share growth and +13% TPV growth for 2023, growing at or near the top end of the digital payments market. Perhaps the crisis imbedded in PayPal's current stock valuation is not so dire. Because the market ultimately acts as a brutal weighing-machine, thus we are strong believers that reality does win eventually, and the reality of the Company's improving fundamentals will eventually be reflected in a more appropriate higher stock valuation.

We will admit we were a bit taken aback when the company provided its initial outlook for flat 2024 earnings per share growth versus 2023, announced on its fourth quarter earnings report in early February. It was difficult for us to see what would cause such a slowdown in the Company's growth rates while the Company was talking about initiatives to improve profitability - especially in the Braintree business.

So, while the market beat the stock up again, our impression is that this guidance was quite conservative. Not surprising, in the couple of months since the Company provided this initial guidance, the management team has been presenting at investor conferences, acknowledging their conservativism. Trends within the business have remained steady in relation to the healthy 2023 trends. The Company continues to implement improved margin plans at Braintree and to push innovations that will be helpful to Braintree's platform of consumer, small business payors, and merchants. The Company is also cutting headcount by +9%, and management will buy back at least as much stock as it did last year, representing another -8% reduction in share count. All of which we expect to be supportive of notably better results than management's initial 2024 guidance.

It is our experience these "wandering bear thesis" stories tend to come to an end at a point that is often difficult to predict. Shorter-term investors tend to move in a herd, meaning a stock can move meaningfully in a short time once the tide turns – that is, as both financial expectations and the multiple the market applies to those expectations rise simultaneously.

We would highlight similar enough dynamics that played out at Meta Platforms, which has been one of our largest holdings for some time. Meta Platforms was a significant COVID-19 beneficiary; the boost to its e-commerce customers led to significant advertising growth rates for the company. With hindsight clarity, they too saw the broad normalization that most everyone else experienced. However, it is important to recall at the same time the normalization was happening, the Company was dealing with a few additional issues - most importantly, changes Apple had made to make it more difficult for the Company to target ads to Apple hardware users, plus seemingly out of control out-sized billion-dollar capex spending. Just as we are seeing with PayPal now, as Meta Platforms investors started looking past these concerning issues, valuation improved noticeably from very low levels. In the fullness of time, the tide turned in sentiment of a secular fundamental turn because the company made some good choices on expense control and capital allocation. The result was rapid and significant move in the stock as reported earnings continue to rebound sharply.

Per our three-decade playbook, it is important to have significant positions in these types of situations before the turning point arrives. While we are certainly not forecasting a similarly-sized move in PayPal stock as in the booming stock of Meta Platforms, we continue to maintain a larger position in PayPal stock in anticipation of this turning point, and we are confident it is coming.

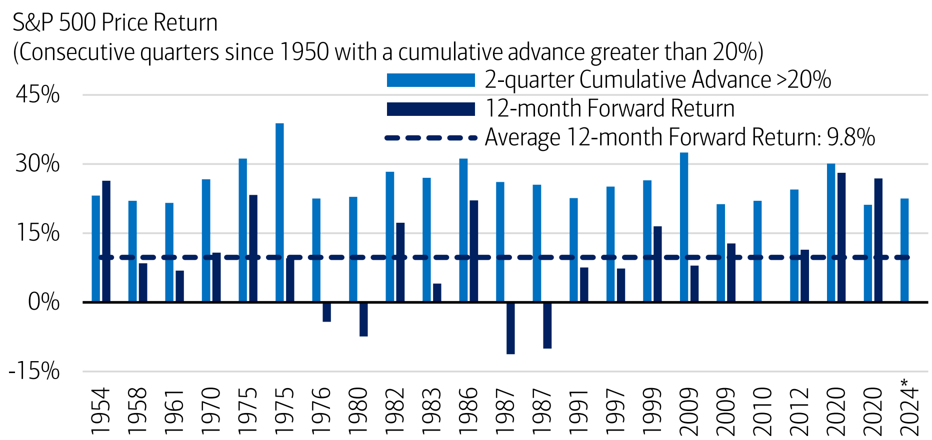
The Magnificent Roaring ‘20’s

The year 2024 is off to a near-historic start with the S&P 500 Index gaining +10.5% during the quarter. Over the past twelve months, the stock market has gained a stellar +29.9%. From the pandemic lows in March 2020, the S&P 500 Index is up *+140%.*

History might suggest that further gains are ahead. If that happens, we will be more surprised than not.

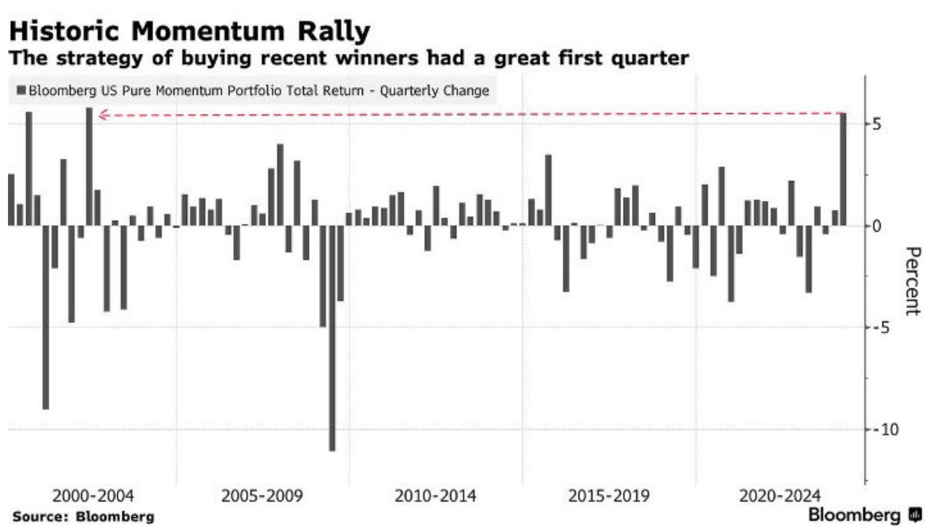
Exhibit 3: Banner Start to the Year For U.S. Equities.

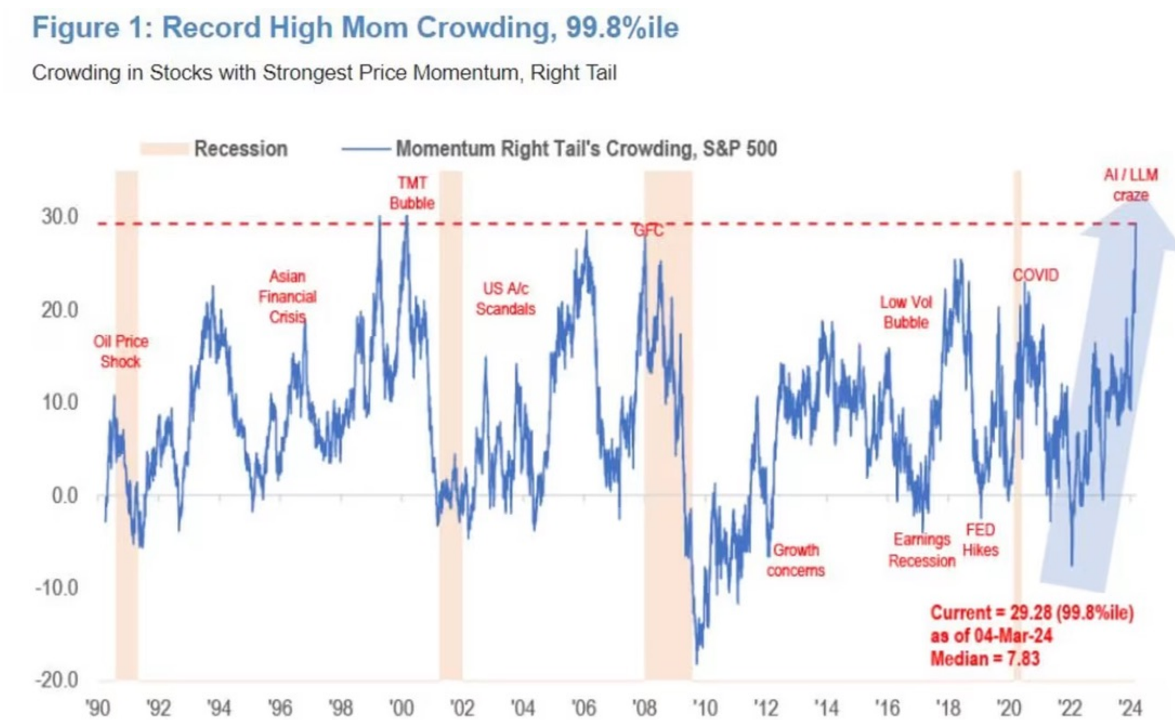
3A) Back-to-back quarterly advances have led further gains.



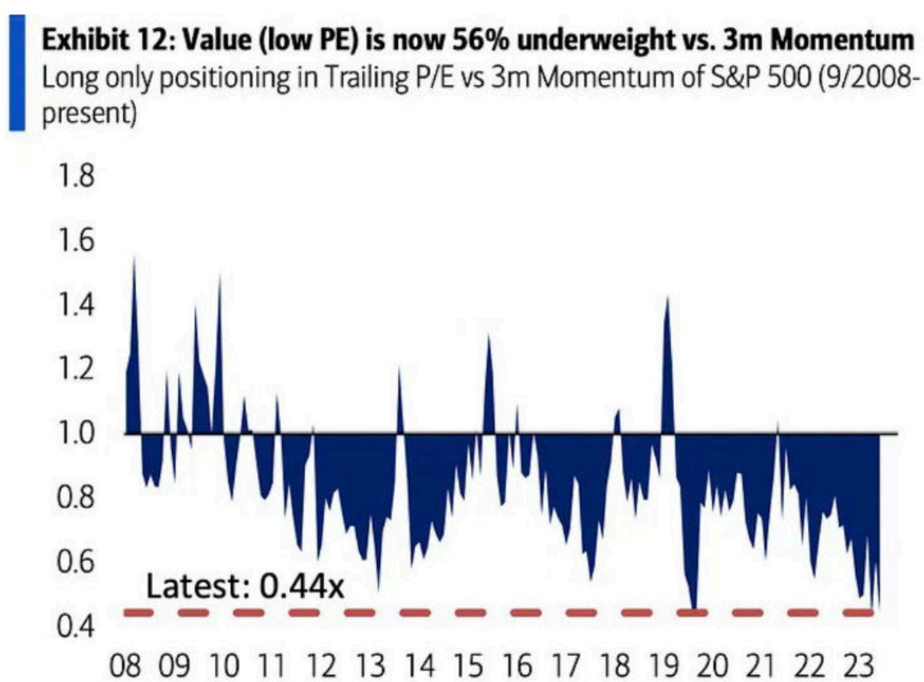
Source: Bloomberg

In addition, “momentum” stocks continue to carry the day - in extremis.





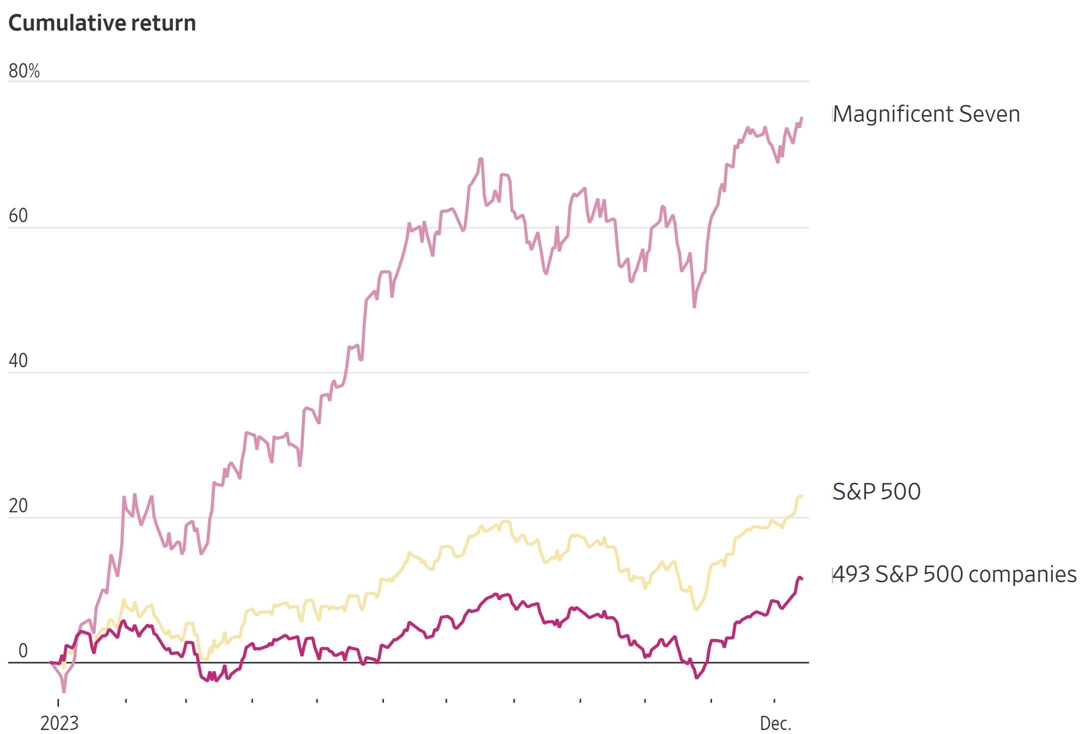
Source: Deutsche Bank



Source: BoA Global Investment Strategy

The so-called "Magnificent Seven" (i.e., Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA and Tesla), also known as the undisputed stars of 2023, continue to mostly forge ahead thus far in 2024. Tesla has been kicked out of the Magnificent Seven club for unsportsmanlike poor company and stock performance; Apple, after a nonstop, stellar run from 2013 through late 2023, is on double-secret probation after a poor start in 2024 and NVIDIA continues to rocket into its own solar system. We are overweight in Meta Platforms and Alphabet and underweighted in both Apple and Microsoft, as we patiently awaiting cheaper valuations to continue to build positions in each.

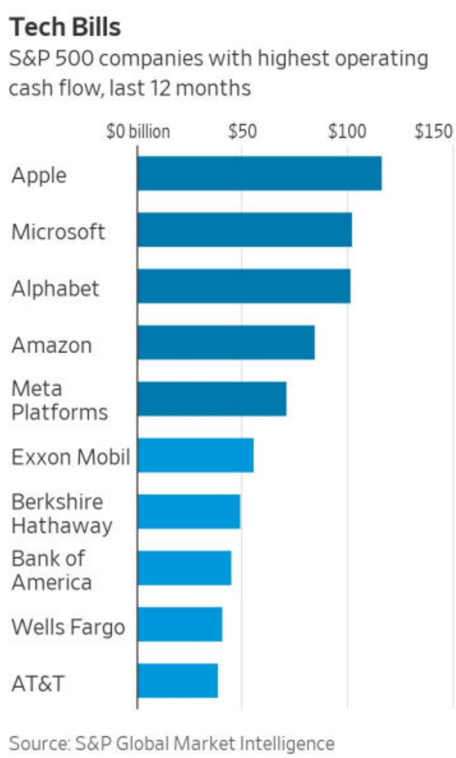
Magnificent Seven in 2023



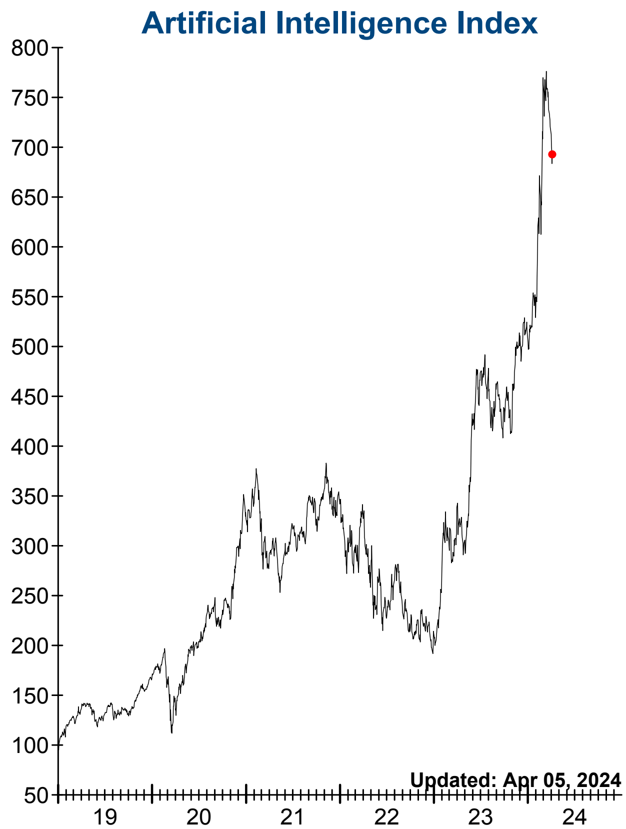
Source: Dow Jones Market Data; FactSet

There has been a growing chorus of angst among market commentators given the cumulative size of the largest technology stocks relative to the size of the overall stock market. Many such graphics do seem to point to worry if one's time frame is just over the past few decades. However, if one expands the time horizon to go back 100 years, one sees that although in the past the current reading of around 75% is certainly spooky given such years as infamous years 1929 and 2000, readings between 65% and 75% have actually been quite common.

Although the stocks of the Magnificent Seven companies might, at times, seem to trade at times as a monolith, yet within our long ownership of such global profit powerhouses, we have experienced plenty of occasions when individual stocks over the many years have charted incredible bull-runs and mind-numbing bear-runs on their own fundamental accord. The sharp periodic declines over the long years in the stocks of Meta Platforms, Apple and Alphabet certainly come to mind. (We have the scars to prove it.)



The most significant performance stars in both 2023 and 2024 have been all-about artificial intelligence (AI). We wrote about our portfolio holdings with stakes in AI in our last Letter. As a reminder, our portfolio holdings benefitting from the secular AI tailwind include Alphabet, Apple, Meta Platforms, Microsoft and Taiwan Semiconductor Manufacturing. Our 2024 performance leaders on this front include Meta Platforms and Taiwan Semiconductor Manufacturing – Apple is the notable laggard.



Source: Investech

Despite inverted yield curves, countless consecutive months of negative leading indicators, and the like, including many calls for a recession in 2022 (which did not happen) and 2023 (which did not happen), plus common calls for some type of economic landing in 2024 (either soft or hard), it appears that the U.S. economy is on cruise control.

The U.S. economy, in large part, has adjusted quite well to the post-ZIRP (zero interest rate) financial environment, thank-you-very-much. You will recall that in our last Letter, we started that Letter with a graphic on the very first page depicting market expectations of Powell & Co.'s cuts in the Federal Funds Rate throughout all of 2024, from 5.33% to 3.95%. And more still for most of 2025, from 3.95% to 3.08%.

Well.

Market expectations have swiftly changed in the growing expectation that the Federal Reserve might not cut the Federal Funds Rate *at all* this year if they do not cut in June (too close to an election after that). A crusin' economy and stubborn inflation (at least stubbornly higher than the Fed's "magical" 2% goal) is becoming all too real.

We lamented in the last Letter the following:

"So once again, 2024 will yet be another year wherein financial markets will be dominated by the often-daily Fed-speak from far too many Fed-pontiff speakers. We caution that the markets might be careful what they wish for. We concede that the Federal Funds Rate is currently too high if inflation stays at current levels. That said, even a cursory review over the decades of significant monetary easing is rarely seen outside of hard-landing recessions."

Our hope is Powell & Co. will largely get out of the way of the economy – and please stop providing pacification to the stock market and credit markets whenever they regularly colic. Let's all hope so. We have long questioned the Fed's institutional confidence (arrogance?) that they, armed with hundreds of PhDs, can somehow micromanage both the economy and too often times financial markets with the blunt force of sharp swings short-term interest rates, as well as yield-curve control via an elephantine-sized balance sheet. Those of us who entered the world of stock picking back in the 1980's cut our teeth on the "Fed Put," first introduced by chairman Greenspan during the 1987 stock market crash. Since then, we've observed more stock market booms and busts arguably caused by the Fed being either too easy, for too long or too tight, for too long. Again, perhaps the markets have finally learned that they do possess brains, hearts and courage and can reasonably adapt to the capitalistic vicissitudes themselves, instead of relying on the behind-the-curtain Wizards of DC in the Marriner S. Eccles Federal Reserve Board Building.

Maybe said building should be moved to Kansas…?

April 2024

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