GCI INVESTORS

GCI Select Equity

Frequently Asked Questions

1. Who are GCI Investors and what do you stand for?

We are an independent, employee- owned asset management firm. Our mission as an organization is to make money for our clients, not from them. And to drive change in our industry to inspire other firms to do the same.

2. What is your strategy?

Our strategy represents a concentrated, fundamentals focused approach to investing. For us, everything comes back to making a genuine investment in a company. As such we take an almost private equity like approach to understanding and analyzing companies. Our decisions are made as allocators of capital, not as traders of stocks. We continually search for the most attractive investment opportunities at any point in time, and we use the public stock market as the means through which we can access those opportunities.

3. How is your strategy different from other offerings?

GCI's strategy is not easily categorized, and therein lies the advantage of its differentiation. Moving beyond traditional labels of market cap, style etc.; our differentiation lies in 5 areas:

- *Value & Growth Mix*: Our process and portfolio does not differentiate between 'value' and 'growth' companies. The way we see it, growth is simply one element of determining value. We focus on finding the best companies we can, and buying them at attractive prices, regardless of how others classify them.
- *All- Cap Universe*: We invest in companies of all sizes, ranging from mispriced mega-caps to unheard of small caps. Our focus is on companies that satisfy our criteria for high quality businesses trading at attractive prices relative to their real intrinsic value, not on any arbitrary size.
- *Concentrated Portfolio*: We typically hold 20 to 25 positions. This enables us to sufficiently diversify single stock risk while also ensuring that capital is focused in the most attractive investment opportunities. Portfolio concentration also applies at a sector level. We are aware that any forecast or estimation involves margin for error, so we have a preference for companies and industries where there are as few variables or items to forecast as possible.
- *Proprietary Process*: We have our own proprietary and repeatable process, Real Intrinsic Value Recognition (RIVR). This process was built to evaluate businesses as long-term owners would.
- *Behavioral Advantage*: Behavior remains a significant competitive advantage in investing. We take a rational, long-term view while the market continues to focus on the short term- this creates opportunities. In addition, we remain resolutely disciplined to our philosophy and strategy, regardless of what the prevailing view may be from other participants.

4. What is your investment philosophy?

GCI was founded on the principle that investing in high-quality businesses at attractive prices is the most consistent strategy to achieve long-term, risk-adjusted returns. Our GCI Select Equity strategy is concentrated, benchmark agnostic and focused solely on the long-term, future free cash flows of the businesses we invest in.

Our investment philosophy rests on four pillars:

1. Invest in Businesses, Don't Trade Stocks

Real investing is about allocating capital to businesses, not buying pieces of paper or trading numbers on a screen. As such, we operate with a business owner's mindset, looking for wonderful companies that we want to be a part of for the long term. We have no interest in poor quality businesses just because they're 'cheap'- we want durable, defensible businesses that can deliver us consistent cash flows for decades.

2. Think Long Term, Don't Time Markets

Short term market movements are driven by news flow and sentiment, and therefore impossible to predict. Not only because of the vast number of variables we would need to get right, but because even if we could predict all those variables with certainty, we still wouldn't know how markets would react to them. As such, we ignore the short-term prediction game and focus instead on the long-term cash generation of the businesses we invest in.

3. Be Concentrated, Don't Overdiversify

Diversification can be hugely harmful to returns. Great opportunities are rare and should not be diluted by average ones. As such, we concentrate our portfolio in the highest conviction opportunities, for the best long-term returns. We accept and are comfortable with the fact that this approach will at times deviate significantly from broader markets. These short-term deviations make no difference to long term returns, and as such make no difference to our approach.

4. Use the Market, Don't Rely on It

Short term market prices only reflect an opinion about underlying business value and those short- term opinions are prone to substantial errors, emotions and biases. The market is effectively a popularity contest in the short run. Stock prices provide us with no information on actual company value, they only provide us with opportunities to transact. As such, we always reach our own opinion about a business's value in isolation of what the market might think, and then we wait for the market to provide us with an opportunity to transact at an attractive price.

5. What is your investment process?

Our investment process is Real Intrinsic Value Recognition (RIVR), it is disciplined, repeatable, and proprietary. At its essence, RIVR involves evaluating businesses as long- term owners would, where we establish an underlying real value for the business itself, based on our expectations of its long-term future. We approach every investment as an investment in a company, the stock market is simply the tool through which we do this.

RIVR requires us to answer two crucial questions before including a business in our portfolio: 1. Is this a high-quality business? and 2. Is it trading at an attractive price relative to its real value? While simple at first glance, answering those questions reliably is very complex.

To answer these questions, we must deeply understand a company's industry, business model, economics, management, culture and financials. This process typically takes at least three months of work, where w are analyzing the company, its competitors, its customers, the industry, long term trends etc. We consume large amounts of information both qualitative in nature and some of which is quantitative. The quantitative data is of course important, but it is the qualitative subjective areas that are really crucial when it comes to truly understanding a business- this is an area that cannot be skipped over and cannot be understood simply through financials. It is this qualitative data that is so often missed by typical stock analysis. We are much less concerned with historic cash flows than we are with future returns- we as investors are buying the future cash flows not the past. And it is only when we know the qualitative side of a business in great depth that we can even begin to consider formulating a picture of the future of that company.

1. Is this a high-quality business?

The term ‘quality’, as typically used by financial market participants tends to be backward looking – i.e. has this company generated high returns in the past? RIVR takes the concept one step further, understanding that what really makes a high-quality business is not only its past returns but its ability to continue generating those returns into the future. Ultimately, that is what we are buying as investors.

As such, a high-quality company must have an identifiable moat or competitive advantage – something structural that prevents competition from eroding profits and returns over time.

There are various quantitative signs that a business currently has a wide moat, such as market share stability, high margins, and high returns on invested capital. However, no amount of historical financial data can determine the future defensibility of a moat. That can only be understood through qualitative analysis. To do this, we need to understand the source of the moat in order to assess its strength. Moats come in many forms such as:

- Network Effects – the value of a service grows as more people use it.
- Economies of Scale – being the largest player creates better economics.
- Switching Costs – customers stay with a company because switching would be too expensive.
- Cost Advantage – being the low-cost producer in a commoditized space.
- Brand – having the most desirable product on the market.
- Regulations – regulatory imposed barriers on competing in a market.

Ultimately, the best way to know a moat will be sustainable into the future is when we have already seen it challenged by a powerful and well-capitalized competitor. The more powerful the attack, the more confidence we can have in the sustainability of the moat.

2. Is the business trading at an attractive price?

Once we have determined that a business is high quality, the next step in our RIVR process is to establish what the business itself is worth to us as long term, owner-oriented investors. We pay little attention to the prevailing ‘market valuation’ of a business- it is fundamentally clear that the market can and does consistently misprice businesses. As such, we reach our own independent estimate of company value, and then we are able to determine if the market is offering us this company at a price we deem attractive or not. To do this, we focus on the long-term economic profits (cash flows) we stand to receive as shareholders, based on our assessment of the quality of the business. We model these returns with a detailed discounted cash flow analysis using explicit forecasts at least ten years out. It is vital that we come to this valuation in isolation of wherever the market is currently ‘valuing’ the business– as any short- term market value is (for the most part) merely a result of sentiment and emotions, not underlying intrinsic value.

Based on the difference between the current trading price and our estimate of intrinsic value, we calculate an IRR (internal rate of return) for each position. The combination of our ruthlessly independent valuation approach and this use of IRR's proves incredibly valuable when it comes to managing the portfolio. If a stock price in the market becomes overvalued, then our IRR will compress- leading us to consider reducing or selling the position and possibly recycling the capital into other positions that exhibit better expected returns. In contrast, when share prices decline significantly, not as a result of a fundamental change in the business but simply as a consequence of market fluctuations, we are likely to be adding to those positions that have been punished most.

We remain humble and aware that valuation is as much an art as a science, with small changes to inputs resulting in large changes to estimated value. After all, our quantitative earnings forecasts are built on our qualitative assessment of a company's competitive advantage. As such, we think about valuations not in absolute share price terms but in terms of a range of returns we stand to receive as investors.

When it comes to updating our valuations, since we are long term business- focused investors we understand that intrinsic company value rarely changes in a matter of days, months, or even quarters. As such we take a pragmatic approach to updating our valuation models; predominantly doing so when events or changes to the company or industry warrant further consideration. Without substantial changes, we will ensure to update our modelling at least annually.

For example, during the Covid-19 crisis we found ourselves updating valuations for most of our names. This meant running cash burn stress tests to see which holdings would be more, or less, impacted by the crisis.

6. How do you source ideas?

We target three areas as the most lucrative for sourcing investment ideas:

1. Inexorable Trends

We spend a significant amount of time thinking about and understanding long-term secular trends (e.g. increasing data consumption, e-commerce, aging populations, etc.) which are difficult or ideally impossible to disrupt. Then, we can begin to consider which businesses are positioned to capture the most value as the trend plays out. As such, we work through the value chain of each trend to establish who is best positioned to benefit – Which companies or industries are involved and stand to benefit? Where are the bottlenecks? Where is the pricing power highest? Where is the competition structurally limited? Where do we think most of the value is going to accrue?

If we get this analysis right and find a wonderful company positioned well, it gives us a substantial margin of safety in our valuation assumptions, in the sense that we can be wrong in the size and scale of a trend, but so long as we get the direction right, we are likely to generate attractive returns. Businesses that fit in this category tend to be our longest timeframe investments with our widest IRR ranges in which we remain holders.

2. Earnings Compounders

There are some unique businesses that have proved they can continuously compound their cash earnings by reinvesting capital at attractive rates. These businesses tend to benefit from some combination of long growth runways, wide moats and a management culture focused on customer satisfaction, cost discipline and generating attractive returns on invested capital. Since these businesses do not (necessarily) benefit from secular industry tailwinds, our margin for error is smaller – i.e. poor management or new competition can quickly erode the economics here. As such, we tend to hold businesses in this category for shorter durations and demand a tighter IRR range to remain holders.

3. Inefficient Markets

Businesses that the market is simply mispricing. These businesses might belong to a currently out of favor sector, their underlying economics might be misunderstood by the market, or for structural reasons, such as liquidity or benchmark considerations, they have been orphaned by investors. In any case, these opportunities tend to only appear at times of extreme market dislocation so when we do make investments in this category, they tend to be our shortest duration, with our tightest IRR range to remain holders.

7. Many investors cite the advantage of long-term investing, what does 'long- term' mean to you?

We understand that stock prices are driven by two things: short term sentiment and long-term fundamentals. When we say, "long-term investing" what we are really saying is; ignore the former and focus on the latter.

When it comes to short term sentiment, even if we could predict economic and geopolitical events with any degree of accuracy, we still could not predict how the market would respond to those events. On top of that, the market is subject at times to both extreme unfounded pessimism and extreme unfounded optimism.

But what we can predict (with varying degrees of certainty) are the economic fundamentals of the businesses we own. If we think a business is going to compound cash earnings at 15% over the next decade, it doesn't matter if its multiple gets cut in half in any single year, our long-term returns will track that 15% earnings growth. Trying to increase this return by jumping in and out of the market and attempting to predict something that is unpredictable is no more than hoping to get lucky. This translates to a genuine competitive advantage compared to many of our peers.

As a result of this long-term focus, investors should judge our performance on a 3yr+ time horizon, even though we are making our investment decisions based on business prospects a decade or more into the future.

8. How do you approach risk management within the portfolio?

Whilst we remain aware of traditional risk metrics such as historic volatility, active money limits, VAR (value at risk) rules, etc., these tools are typically backward looking and have proved themselves to be ineffective at the very times they are needed most; times of crisis. Put simply, to us volatility is not a measure of risk. Volatility measures only the short- term movement in price- not changes in intrinsic value. In addition, using volatility as a risk metric typically leads investors to make the wrong decisions at the wrong time: for example, in an aggressive market sell-off volatility spikes, leading many investors to sell stocks. When in fact, they're now being offered the same asset at lower prices, so they should be doing the exact opposite of selling- they should be buying.

We maintain that the best way for any investor or portfolio manager to control risk is to understand what they own. As such, our focus is on controlling the risk at the company level. By understanding each of our portfolio companies in great detail we can have confidence in underlying earnings and the real value of a business regardless of short-term share price movements. It is only when we are confident that a company's future earnings growth (and therefore value) is secure that we can have the confidence to add to positions during large sell offs.

This approach is combined with intellectual honesty and the humility to adjust both our forecasts and portfolio positions when our original thesis is no longer applicable, or when the market has bid the stock up to unattractive levels (compressing our expected returns).

9. How do you manage position sizes?

Our typical position size is between 3%-8% of the portfolio. Our position sizing takes into consideration our confidence in earnings projections, the implied internal rate of return we are receiving on those projections, our overall portfolio risk, and concentration of end market exposure.

10. Is running a concentrated portfolio risky?

We typically hold 20-25 positions within our strategy- this number enables us to sufficiently diversify single stock risk, but remain concentrated enough that we can still have capital focused in attractive investment opportunities.

In terms of risk, it is far less risky to own 20 companies that we know extremely well and in which we are confident in the future earnings and real value, than it is to own 200 companies we know little about.

High-quality companies are rare. High-quality companies trading at attractive valuations are even rarer. If we forced ourselves to hold more positions despite this fact, we would end up with many average investments. We are not looking for average investments or average results. Instead, we seek to allocate capital where it can achieve the best long-term, risk-adjusted returns. This strategy is supported empirically in research that has shown that around 90% of the benefit of diversification is achieved by holding just 15 positions, so there is little diversification benefit obtained by holding substantially more than that.

11. Please explain how you can own both Value & Growth stocks?

For some reason, the terms "value" and "growth" investing have been marketed as opposing ideas by Wall Street and the financial media. In reality, everyone should be aiming for 'value' investing – in the sense that value investing involves purchasing a business at a price below its real intrinsic value. However, for us to be confident that we're buying a business beneath its intrinsic value, we have to work out what the real intrinsic value is- and growth is one of the many variables we need to consider in that process. Sometimes growth will be a major part of the intrinsic value, sometimes it will be negligible, and sometimes it can even be negative in terms of contribution to intrinsic value (if a company is investing shareholder capital in negative return areas).

Common yardsticks of ‘value’ such as P/E, dividend yield, book value, etc. tell us little about the real intrinsic value of a business (a company can have a high P/E and be cheap relative to its real intrinsic value). Similarly, whether a business is growing its top line tells us little about its ultimate prospects as an investment (a fast-growing company could be destroying shareholder capital). Instead, what we are focused on are the long-term, moat-protected future free cash flows of the businesses we invest in.

12. Do you incorporate ESG into your investment process?

Our investment process includes the consideration and in-depth analysis of a wide variety of factors, including environmental, social and governance (ESG) factors. We regard Responsible Investing as a core part of all genuine long-term investing and not as an addition to an investment process, nor as an additional threshold that needs to be met. In addition, we hold ourselves to an extremely high standard as stewards of our client’s capital.

Our approach is entirely fundamentals based; rooted in a deep understanding of the individual company in question. We do not utilize many of the industry standard metrics or methodologies- we simply do not believe these are appropriate nor useful to genuine investors. Large numbers of ‘ESG’ scores and metrics now exist that rank companies on all manner of different variables. Thousands of investment products (both active and passive) now invest solely on those scores, proudly displaying the words ESG or ‘Responsible’ in their marketing as they do so. In reality these scores are mostly meaningless.

The problem is that ESG and Responsible investment characteristics are almost entirely qualitative in nature. As such, they cannot be ‘scored’ or ranked based on an algorithm. When you take something that is qualitative and subjective in nature and force it into a quantitative framework, you end up with an output that doesn’t have much real-life value. To truly understand ESG impacts, investors must do the hard work of deeply analyzing the individual company and the industry as a whole. Only then is it possible to establish the real impact of ESG and PRI principles. Ascribing a number or letter scoring system to such complex and qualitative variables simply misses the point and misses the real impact of these issues.

In addition to ignoring the misguided way in which the majority of our industry approaches ESG, we also do not take any explicit political or religious approach in our assessment of individual companies. Instead, we passionately believe that our real world and fundamentals-based approach is the best way to uncover real issues and real impact and allow us, as investors, to either avoid danger areas, find positive areas, or engage with firms to bring about positive shifts at a variety of levels.

13. Do you apply ESG factors in your own firm?

Not only do we regard Responsible investing and ESG considerations as a core part of our investment philosophy and process, but such considerations are also at the forefront for us as a company.

Environmental
GCI Investors aims to be a 100% carbon neutral organization. We have achieved this standard in two ways, firstly through efforts to reduce and reuse: reducing consumption of various items (paper, batteries, disposable items, travel etc), as well as greater recycling. Secondly, we also employ carbon offset as a company, by planting

sufficient trees each year to offset the carbon dioxide we produce that is (at the moment) more difficult to eradicate entirely- for example electricity consumption.

Social
GCI Investors prides itself on excellent and flexible working conditions, employee compensation and benefits. We are actively engaged with our clients, as well as the wider community. A large proportion of staff are also involved with a variety of local and national charitable organizations.

Governance
GCI Investors is 100% employee and minority owned, and we incorporate ESG considerations at all levels of the firm. Our longstanding family ownership allows us to take a truly long- term approach to our business, without being swayed by the short term machinations of traditional external shareholder ownership.

Internally, we believe that culture is essential to building a sustainable investment firm. Our organizational culture is built on respect, open dialogue, intellectual curiosity, and a passion for investing which is shared by each of our team members. Our goal is to operate in a team-based, investment-focused environment that nourishes collaboration, creativity, and constructive debate. As such, and in addition to the investment considerations described above, we continuously look for ways to improve our own ESG performance.

GCI Investors has an extensive privacy and data security policy. External audits have been conducted regularly and consistently produced unqualified opinions.

14. How do you approach client service?

We focus a great deal on client education. We believe that the investment industry in general does a very poor job of serving, educating, and doing the best for clients. We produce a considerable amount of investment research, commentary, and analysis. This commentary and research is also available for our investment partners to use with their own client base, in addition to elements of our primary equity research and company theses. As an indication of our commitment to industry thought leadership we have recently published a book which further details our approach to investing, and how it is different from so much of our industry today (Navigating the Street: A Better Approach to Investing, available on Amazon). We feel that the best way for clients and investors to understand our strategy is to understand the companies we own, and why. Members of our investment team also participate in conferences/ seminars organized by our investment partners, where we can share our research strategy and outlook in a live format. Our investment team are rarely happier than when analyzing or discussing businesses and investment opportunities.

15. Is your relatively small investment team a constraint?

We do not believe a large team is necessary (or often even helpful) when it comes to generating long term returns. We make a concerted effort to stack the odds in our favor, to increase the likelihood of investment success. By choosing to invest behind inexorable trends, or in those companies with truly unique business models, we hugely narrow the investable universe. There simply are not that many companies that meet our criteria to be sufficiently attractive that we would need an army of analysts to understand them all. Unattractive or very hard to predict investments, such as those heavily reliant on unpredictable commodity prices or regulatory approvals are immediately excluded from consideration, leaving us with a very manageable number of potential targets. Long term investment success is created by depth of thinking, not breadth of analysis.

16. How are final trade decisions made? Who is accountable for these decisions?

Buy and sell decisions are typically reached as a team. Ideas are discussed and critically evaluated by all members of investment team. As such, accountability is at a team level and the testing and critical analysis of any thesis is actively encouraged. Such an approach removes a lot of the behavioral biases that come with personal overattachment to ideas or any other personal agendas. Where necessary, final authority lies with Guy Davis.

17. When do you sell positions?

We apply the following criteria to determine when to exit positions:

- Change in the investment case: if our original buy thesis has either played out or been altered by events/ news flow or has proved to be incorrect (intellectual honesty and humility is vital in investing).
- Valuation: the share price approaches or exceeds our assessment of fair value (any assessment of a security's fair value is subjective and therefore should be thought of as more of a 'range' than an absolute share price level), such that our expected return is insufficient to compensate for the risk.
- Competition for capital / portfolio considerations: prices approach a level where our expected returns are lower than we could achieve in other positions OR if the stock is no longer appropriate given the overall portfolio risk profile/ desired positioning.

18. Can you give an example of an investment idea that did not work as you intended?

Through our RIVR approach, we found that International Flavors & Fragrances (IFF) was a high-quality business trading at an attractive price. However, we have since sold our position at a loss as the business dramatically changed at the end of 2019.

When we initiated our position in mid-2019, IFF shares had sold off substantially due to the announced acquisition of Frutarom which the market believed was overpriced.

We believed (and still do) that the Flavors and Fragrances industry was high quality – an oligopoly with rational competition, providing a keystone product which makes up just a tiny percent of their end customers cost structure. Even considering that IFF overpaid for their acquisition, the acquisition made good strategic sense to us – allowing them to exercise substantial revenue and cost synergies over the medium term. As such, our estimate of real intrinsic value was higher than where shares were trading and we took a position.

Fast forward a year and whilst we were correct that projected synergies from the deal were being achieved ahead of schedule, there came an announcement that surprised us. IFF had won a bidding war against Kerry to acquire DuPont's Nutrition Unit. The management of IFF had been very explicit that after the complex integration of the Frutarom acquisition they would stay away from any substantial deal making, so to discover another large deal such as this was concerning. We lost confidence and trust in IFF management and were concerned that they were spreading themselves too thin by trying to integrate two mega deals at the same time. Such work would likely take years to complete, and our returns as investors would for the foreseeable future be driven by management's ability to integrate these acquisitions, not the underlying company and industry fundamentals we were originally attracted to. As such, we sold the position entirely.

19. Your strategy is All-Cap, but what is your edge in a heavily followed mega-cap business like Microsoft?

We think the market overall often does a poor job of valuing even mega cap companies like Microsoft. This is largely because the market is too focused on screens, quantitative metrics based on GAAP accounting and short -term valuation methods, rather than focused on doing the difficult work of trying to understand the real underlying economics of these businesses. Over reliance on quantitative metrics places an over emphasis on historic returns, and yet as investors we are inherently buying the future returns, so that is where we aim to focus our attention.

As an example, Microsoft is growing at a very high rate and they are expensing, rather than capitalizing, significant investments made in coders, developers, etc. to build out platforms for which they will be able extract value from for years to come. The accounting story here is a business where the ultimate economic value lies in the future, driven by substantial long- term market growth, and excellent competitive positioning.

Compare this approach to much of the market that is passive and purely quantitative – lacking the necessary in- depth analysis to understand the real underlying economics of these businesses. We believe that is where our edge lies.

20. What is your portfolio turnover on an annual basis?

We think about turnover in terms of portfolio company turnover – how often are we entering new positions or exiting old positions. Traditional turnover metrics can often be misleading when managers are managing position sizes based on valuation changes. For example, during 2020 we saw substantial market volatility which presented us with unprecedented opportunities to shift weightings within our already established positions. Throughout the entirety of 2020 we executed two significant portfolio changes – The first involved buying more of our positions that had sold off unnecessarily during March, funded by selling some of our positions that held their value. The second was to reverse this in May once the market had normalized. Our focus on IRR led us to generate significant returns during this relatively short period. However, as a result this highly unusual circumstance, our turnover numbers on traditional metrics would appear to be high during 2020, even though we only added two new companies to the portfolio during the year.

21. How is your team incentivized?

Our team members receive a base salary, as well as an annual performance related bonus. This bonus is a function of our strategy's investment performance over rolling one, three, and five-year periods with more weight given to the long term. As such, our interests as employees are aligned with those of our clients. Our portfolio manager Guy Davis is also an equity partner in the firm.

22. How would you describe your firm culture?

Culture is essential to building a sustainable investment firm. Our organizational culture is built on respect, open dialogue, intellectual curiosity, and a passion for investing which is shared by each of our team members. Our goal is to operate in a team-based, investment-focused environment that nourishes collaboration, creativity, and constructive debate. We do not seek to model ourselves on traditional investment industry practices, and instead choose to create a culture that fosters curiosity and collaboration, and is focused on investing above all else.

Key to our success are our core values:

- Remain Rational – Thoughtful Rationality guides all our decisions.
- Be Independent – We have courage in our independence.
- Embody Excellence – This is a competitive industry and excellence is vital.
- Communicate with Candor – We hold honesty and integrity at our core.
- Empower with Freedom – We are investors first, partners second, and employees third.

Disclosures

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