Alley Company Quarterly Letter
Secret Sauce

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Among the traditional determinants of growth in economic output are factors such as hours worked, labor participation rate, and general population demographics. In recent decades, however, economists have taken a closer look at the role of *innovation* within an economy and its impact on growth. Some economists now estimate that over half of the growth in gross domestic product (GDP) is the result of innovation.[1]

While innovation is commonly thought of in terms of breakthrough products such as the lightbulb, automobile, or computer, it also can manifest itself in basic process improvements, new services, or simply staying relevant to customers in a rapidly changing world. The contribution to growth (and profitability at the company level) comes when innovation is *useful* and of *value* to customers.

Innovation, no doubt, is a global phenomenon, but the U.S. in particular benefits from a proven market-based system that rewards thoughtful risk taking and entrepreneurialism within a regulated environment. The combination of these elements is the "secret sauce" behind America's productivity and its economic dominance* over the past century.

In the U.S., innovation is omnipresent: at Procter and Gamble, they describe it as the "lifeblood" of their organization; at Google, they operate under their self-defined "eight principles of innovation;" and at universities around the country, it flourishes. One of the keys to successful innovation is the ability to embrace long-term thinking. Amazon CEO Jeff Bezos captured the essence of this when he said:

> *"I don't think that you can invent on behalf of customers unless you're willing to think long term, because a lot of invention doesn't work. If you're going to invent, it means you're going to experiment, and if you're going to experiment, you're going to fail, and if you're going to fail, you have to think long term."*

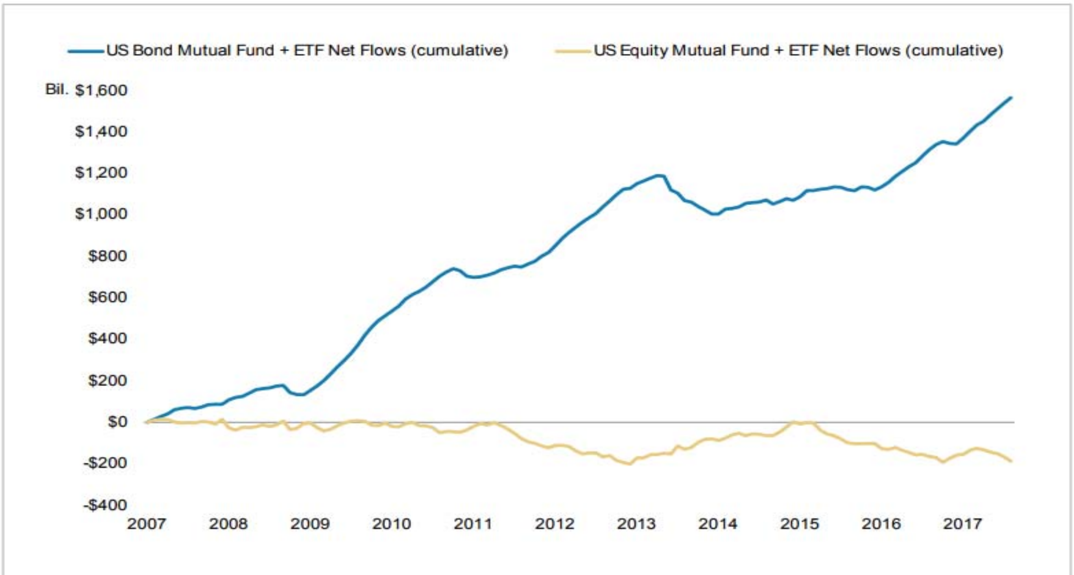
Alley Company LLC
585 Bank Lane, Suite 2400
Lake Forest, IL 60045
Phone 847-482-0938
Fax 847-482-1237
www.alleycompanyllc.com

Thinking long term is also part of the "secret sauce" for investors. Time needs to be given to an investment to allow it to reach its potential. This is not to say that a "sell discipline" should not be adhered to, because it should. However, our investment philosophy guides us toward trimming positions in companies that are "off track" as opposed to those where companies are performing well fundamentally and are "in sync." The following quote from legendary Fidelity Magellan portfolio manager, Peter Lynch, sums this up pretty well:

> *"My biggest mistake was that I always sold stocks too early. In fact, I got a call from Warren Buffett in 1989. My daughter picks up the phone and says, 'It's Mr. Buffett on the line.' And I thought some of my buddies are kidding me because she was only 6. And I pick up the phone, and I hear, 'This is Warren Buffett from Omaha, Nebraska.' You know, he talks so fast. 'And I love your book One Up on Wall Street, and want to use a line from it in my year-end report. I have to have it. Can I please use it?' I said, 'Sure, what's the line?' He says,* ***'Selling your winners and holding your losers is like cutting the flowers and watering the weeds'****(emphasis added)."*

Great companies are constantly innovating, investing the appropriate time, talent, and resources to solve problems and maintain growth. In 2016, for example, aggregate research and development (R&D) expenditures by S&P 500 companies totaled over *$250 billion*, which was slightly more than Finland's entire GDP. These investments today create the revenue and profitability of tomorrow which drives total shareholder return (TSR) over the long term. TSR is comprised of both price appreciation and dividends received and is the reward that equity investors receive for taking on more risk than bond investors.

Over the past decade, innovation has continued apace – the smartphone has computing power that exceeds that of NASA's computers during the Apollo mission and hydraulic fracturing has moved the U.S. closer to energy independence. Nonetheless, since 2007, the cumulative net flows in markets have vastly favored the "safety" of bonds relative to the "risk" of stocks (see exhibit on top of next page). These fund flows offer a view into the mindset of the average investor and provide some argument against the notion of a frothy stock market.



Source: Haver Analytics, ICI, Morgan Stanley Research

Both innovation and investing need long-term thinking. With today's R&D focused on exciting new breakthroughs such as driverless cars, artificial intelligence, and gene therapy, we expect economic growth to continue to be the beneficiary of innovation over the long term. Moreover, there will be many innovations in the future that today we cannot even imagine.

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[1] The impact of innovation on GDP growth has been estimated to be in the range of 50-85 percent, per www.chamberfoundation.org and a paper written by Nathan Rosenberg, Professor of Economics (Emeritus), Stanford University, entitled Innovation and Economic Growth.

* The U.S. has been the powerhouse of the global economy for well over a century now. In 2016, the U.S. accounted for 24.3 percent of global GDP, yet only 4.3 percent of the earth's population. China, meanwhile, has the second highest level of GDP globally, and if they had the same level of output per citizen as the U.S., their GDP would be 6x higher.