Alley Company Quarterly Letter
Stand the Test of Time

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To say that the year 2020 has flummoxed the psychology of investors is an understatement! This reality has negatively exposed those that lack a disciplined investment approach as a baseline from which to manage risk and return.

One of the most critical elements of investing is the existence of a set of beliefs and principles that guide the decision-making process. Without a disciplined *investment philosophy*, investors are far more likely to make ill-advised decisions, especially during periods of elevated uncertainty or market volatility. Our investment philosophy in the equity markets is to take a long-term approach with the objective of reaching client goals and outpacing the deleterious effects of inflation over time. In the portfolios, we strive to accomplish this through the ownership of a diversified group of quality companies with proven track records of success and favorable future business prospects.

Over the long pull, we view the quality American businesses that we invest in as "compounding vehicles." Compounding is one of the most important concepts for investors to understand. It occurs when future returns are earned on past returns. Albert Einstein referred to it as "the 8th wonder of the world." Quality portfolio holdings tap into the power of compounding in two potential ways: i) astute management teams reinvest excess cash flow from the business back into productive operational assets which can earn future returns, and ii) attractive and growing dividends paid to shareholders are reinvested in the portfolio.

Over shorter time periods, particularly when markets get choppy, quality companies can offer better downside protection relative to companies with weak fundamental positioning or shaky balance sheets. Downside protection can occur in two ways: i) investors see the long-term value in companies that can actually *expand* market share during challenging times *and* make important investments in future growth during these periods (i.e., they have the ability to stay on the offensive), and ii) with the perception of long-term dividend sustainability, the stocks of quality companies will find "yield support" in the market as rising dividend yields become more attractive to prospective investors.

Net, quality companies can stand the test of time over market cycles, allowing investors to have the confidence and peace of mind to focus on an appropriately long-term time horizon in achieving their financial goals. For a more detailed read of our view on quality companies, please see our recent Commentary: Quality: In the Eye of the Beholder (www.alleycompanyllc.com).

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COVID-19 and the attendant economic challenges have created elevated market volatility and also reminded investors of the risks of owning less-than-quality companies. When the breeze is at everyone's back, lower quality companies can perform as well or even better than stable companies for a period of time. But when the wind starts to swirl and storms hit, market cycles can turn quickly and companies with challenged long-term business prospects or overly leveraged balance sheets typically become exposed for their shortcomings and their share prices can suffer harsh fates. The table below depicts the simple but cruel mathematics of the trek back to breakeven for a stock that has suffered a significant market drawdown. Low quality and volatility can be a dangerous mix, especially if fundamentals become so impaired that permanent losses develop.

The Cruel Math of Returning to Breakeven

Loss Incurred	Gain Required to Break Even
-20%	25%
-30%	43%
-40%	67%
-50%	100%
-60%	150%
-70%	233%

The intrinsic value of a quality company with sustainable business fundamentals is made clear by looking through the lens of traditional valuation models. Below is the formula for the discounted cash flow (DCF) model, which emphasizes how **stronger expected long-term performance equates to higher present value.**

Basic DCF model:

$$DCF = \frac{CF_1}{(1+r)^1} + \frac{CF_2}{(1+r)^2} + \ldots + \frac{CF_n}{(1+r)^n}$$

Where,

- **DCF** = Present value of future discounted cash flows that a business is expected to produce
- **CF** = Cash flow for a given year
- **r** = Discount rate

Great American businesses that are resilient and nimble have the wherewithal to produce sustainable long-term financial performance. This is what gives the market confidence to look out into the future while the average investor may be fixated on current conditions and the unstable ground at their feet. Additionally, in today's environment, the opportunity exists to produce favorable operating leverage in the not-too-distant future as a recovery in revenue growth is spread across more controlled expenses.

An investment philosophy that focuses on quality companies can stand the test of time for investors, providing compounding characteristics for the long pull and downside protection during challenging times. With the elevated uncertainty of a global pandemic and a tense U.S. political environment, our view is that a continued focus on proven companies offers the best prospects for meeting objectives in equity portfolios and achieving attractive risk-adjusted returns over time.