



Wedgewood Partners 1st Quarter 2015 Client Letter

Crude Realities ... and Opportunities

The game of making money in the stock market is deceptively simple. It is one of the few businesses where one makes offensive decisions and is not forced into making defensive ones. You play the game only when and where you wish to. You need only swing at the fat pitches, which are over the plate and belly-button height.

Warren Buffett

Review and Outlook

The Great Bull Market of 2009-2015 celebrated its 6th anniversary this past March 9th. During the first quarter our Composite (net-of -fees) performance was roughly flat (+.57%). The S&P 500 Index was a bit better at +.95%. However, we significantly underperformed our benchmark, the Russell 1000 Growth Index, which gained +3.84% during the quarter

Outside of one fat recent pitch, we haven't been swinging at much at all over the past year or so. Plus, on the performance front, there has been little to celebrate of late here at Wedgewood Partners. Worse still, our relative returns over the past twelve months have been among the poorest in our strategy's +22-year history. For the trailing twelve months ending this March our Composite's gain of just +7.78% significantly underperformed both the S&P 500 Index and the Russell 1000 Growth Index by -495 basis points and a whopping -831 basis points, respectively. While we are proud of our long-term performance record, we are quite certain that our newer clients that have entrusted us to manage their money over the past year are none-too-pleased with us – we dare say that we deserve the boos too from clients that have joined over the past two years as well.

During the quarter our portfolio turnover was reduced to sloth-like activity. We trimmed three holdings due to richer valuation – Cognizant Technology, Stericycle and Varian Medical. We added to just two, due to more attractive valuation – Qualcomm and National Oilwell Varco.

Our largest detractors during the quarter were National Oilwell Varco, Berkshire Hathaway and Qualcomm. Our best contributors during the quarter were Cognizant Technology, Coach and Verisk Analytics.

Now may be as good a time as ever to comment on and share our own performance expectations. We believe that a five-year time horizon is a long enough time frame to judge the merits of any money manager. Some may say three years is plenty of time, but we prefer at least a five-year time horizon – particularly for Focused managers. Why the special consideration for a Focused investor you ask? Simply put, we believe that the only systematic way for active managers to outperform over meaningful time horizons, and in both bull markets and bear markets is to be as different as possible from the investing crowd. The hardest ways, in our view, to try to outperform the market (and one's peer group) is to think you possess an IQ and/or an informational advantage. If an individual (or firm) may in fact possess either, we believe such advantages are fleeting and not repeatable.

Therefore, we think the “easiest” way – if one dares - is to be a Focused investor. Market indices and benchmark portfolios typically hold +500 stocks. Most active managers hold dozens of stocks. We only invest in 20 or so. We strongly believe that our focused investment philosophy and process is not only our *long-term* competitive advantage, but is repeatable in most economic and market environments.

Focused investing is also the main reason why we have had periods of significant underperformance over the past two decades. Put another way, this is not the first time we have underperformed our benchmark by this wide of a gulf, and it most assuredly will not be the last. Indeed, if we are true to our differentiated focused philosophy and process, and *do not* chase the industry darlings of the day, then we *must* endure periods of underperformance.

In terms of our historical annual portfolio returns, in order to help set client expectations of Wedgewood...i.e., “*We have been here before*” and “*This is what annual Focus returns look like,*” please consider the following:

Over the past 22 calendar years (1993 thru 2014) there have been 12 calendar years where we have under/out performed the benchmark Russell 1000 Growth Index by 500 or more basis points. In nine calendar years we have under/outperformed by 900 basis points. Three of those calendar years we underperformed by at least 800 basis points.

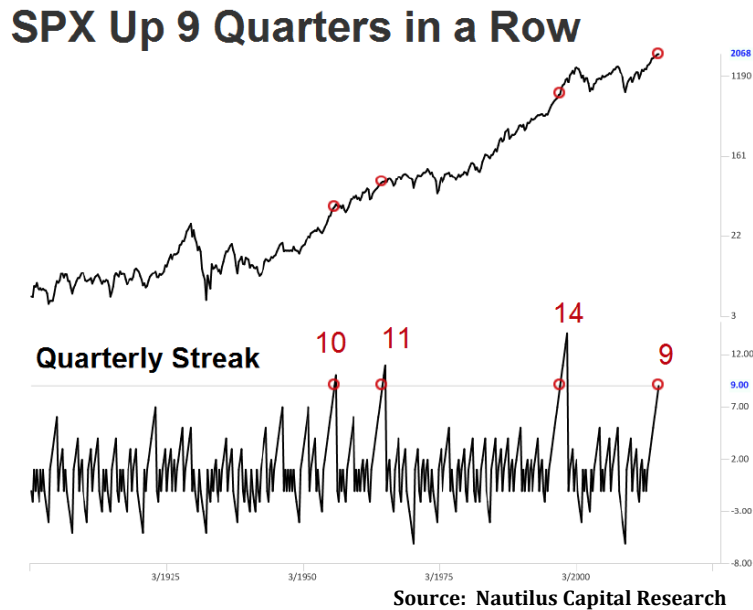
1993: -911 bps
1997: -939 bps
2006: -1,186 bps

If we assume that the trailing twelve months ending the first quarter 2015 was a calendar year, then we have underperformed the Russell 1000 Growth by +800

basis points (actually, again, +831 bps) for the *fourth* time in our firm's history. During each of these four inglorious periods, we have found ourselves in the teeth of a relentlessly advancing bull market.

Consider:

- From 3Q 1994 through 2Q 1998, the Russell 1000 Growth Index rallied 16 quarters in a row; we underperformed by -939 bps in 1997.
- From 2Q 2005 through 3Q 2007, the Russell 1000 Growth Index rallied 9 out of 10 quarters; we underperformed -1,186 bps in 2006.
- Currently, the Russell 1000 Growth Index (and the S&P 500 Index) has rallied 9 quarters in a row; we have underperformed -831 bps over the trailing 12 months.



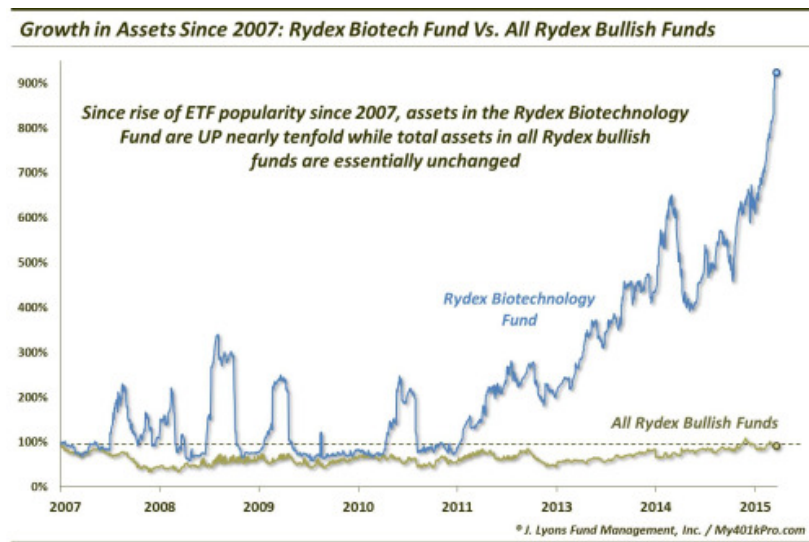
Those clients who have invested with us over the past ten years will recognize some similarities of our current poor performing streak with our last poor streak in 2006. Often in focused investing it's what you don't own that can hurt your relative returns the most. For example, even if we factor in the "mistakes" of our poorest performing holdings over the recent twelve months (National Oilwell Varco, Qualcomm and our cash holdings) we still would have performed poorly over the past twelve months. Notably still, just 7 out of our 22 portfolio holdings underperformed our benchmark.

So what don't we own that has hurt our relative performance? Admittedly it is difficult to cite individual stocks, however, we have a pretty good idea where to start.

In the current environment of decades low interest rates in the U.S. (plus, centuries-old low in interest rates around the globe), yield related stocks have been at the forefront of the performance derby. Utility, REIT and high dividend yield consumer defensive stocks have significantly outperformed over the past 12-18 months.

Another source of underperformance, and one of the biggest winners during the Great Bull Market, has been healthcare stocks – particularly specialty pharmaceutical stocks, led by biotechnology stocks.

Given our strong predilection to invest in growth companies rather than high dividend paying companies, our lack of exposure to utility and REIT companies should come as no surprise. However, we have always invested in a myriad of healthcare companies over our +22-year history. The list has spanned the gamut from medical device companies, pharmaceuticals and biotechnology to both HMOs and PBMs. That said, our lack of exposure of late in the very best performers – biotechnology – is, in our view, Exhibit A in Mr. Market's current infatuation in the darling's of the day.



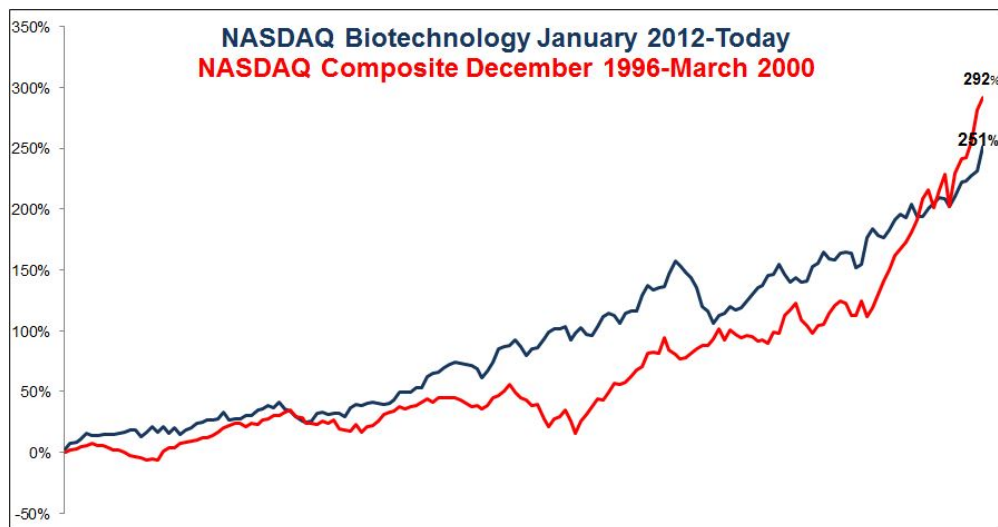
According to Morningstar, healthcare stocks have compounded at three and five-year rates of +25% and nearly 20%, respectively – and nearly 22% over the past twelve months. Carving out biotechnology stocks from these sector returns finds the biotechnology stocks have compounded at +34%, +37% and +29% over the past 1, 3 and 5 years! According to Credit Suisse, since the beginning of 2011 through late March 2015, the NYSE ARCA Biotech Index has delivered 204% performance vs. 64% for the S&P 500 Index. Further, the cumulative market capitalization of the five largest biotech companies (Gilead Sciences, Amgen, Biogen, Celgene and Regeneron Pharmaceuticals) is \$450 billion, up from \$128 billion at the beginning of 2011 - and \$82 billion at the beginning of 2001. (We have previously owned both Amgen and

Gilead.) There are currently 44 public biotech stocks with market caps (outside the 5 largest) greater than \$2 billion - 1 year ago there were only 26 and in 2011 just 14. Furthermore, the number of biotech IPO's in 2014 (82 IPOs) has exceeded the previous peak of 67 IPOs in 2000. There have already been 12 IPOs so far in 2015.

These are staggering numbers...

However, each time we have come to analyze a biotech stock valuation, particularly of late, we have had to assume historically unprecedented addressable market growth and/or market share take. So it was not a coincidence when Express Scripts, (one of the portfolio's holdings) recently suggested in its widely regarded, annual Drug Trend Report, *"absent more fair drug pricing, (US) payers will face half a trillion dollars in prescription drug costs as soon as 2020."* which is almost double what US payers spent in 2012 (according to the U.S. Centers for Medicaid and Medicare Services). While we have our own calculations, we do not disagree with this assessment, particularly in light of the implied revenues necessary to justify the aforementioned, incremental market cap. Witness, during the quarter, Gilead Sciences announced it was cutting prices nearly in half for its Hepatitis C therapy, after just over 12 months on the market. We can only speculate, but it was not for a lack of demand – instead, the previous asking price would have wrecked havoc on payer budgets. So while we have the utmost respect for the innovation and the substantially better quality of life that many of these companies provide, we also think that the potential financial returns are finite.

Shades of the 1999-2000 DotCom Bubble?



Source: The Irrelevant Investor

Our underperformance is not exclusively driven by healthcare. The bane of our poor returns in 2006 was our lack of credit sensitive financial stocks and cyclical stocks in our portfolio. In 2006 - and into early 2007 - the tailwind of the soon to burst credit bubble rendered a portfolio of high quality companies, that never needed to boost their portfolio with cheap and easy credit to begin with, quite impotent. Indeed, while our portfolio returns were stuck on Do-Not-Go, cyclical stocks such as the 40-stock Morgan Stanley Cyclical Index were making +35-year relative performance highs versus the S&P 500 Index. That nirvana for cyclical, lower quality stocks lasted into the spring of 2007. The canary in the coalmine that announced that the credit boom/bubble had burst was the sudden meltdown (and failed company bailout) of Bear Stearns mortgage related hedge funds. The financial world suddenly became a much different place – and our relative returns snapped back quite sudden as well. In fact, eventually some of those cyclical companies with higher quality business models would go on to be cheap enough for us to purchase!

Ok so, that's the bad news on our performance front – and it no doubt has been unquestionably bad of late. We do though have some good news to share as well. Those inevitable years of underperformance often set the stage for attractive future returns, as we have outperformed during 5 years by at least 1,000 basis points and 2 other calendar years by 2,000 basis points. In other words, 40% of the time we have been managing a Focus portfolio for the past +22 years our performance differential versus the benchmark has been plus/minus 900 bps. In those 9 calendar years, the annual performance differential has averaged 1,400 basis points! Furthermore, after our worst periods of underperformance we have tended to rebound sharply. On a *relative basis* versus the Russell 1000 Growth Index, after a poor 1993 we performed well in 1994 and 1995, after 1997 we went on what would turn out to be ridiculous 6 consecutive calendar year tear from 1998-2003. Then, after a very poor 2006 (and early 2007), we posted some of our best downside performance capture in our careers during the Great Bear Market of 2007-2009. Following that numbing bear market, we bounced back quite strong in 2009, paused a bit on a relative basis in 2010 and then again strongly outperformed in 2011 and 2012.

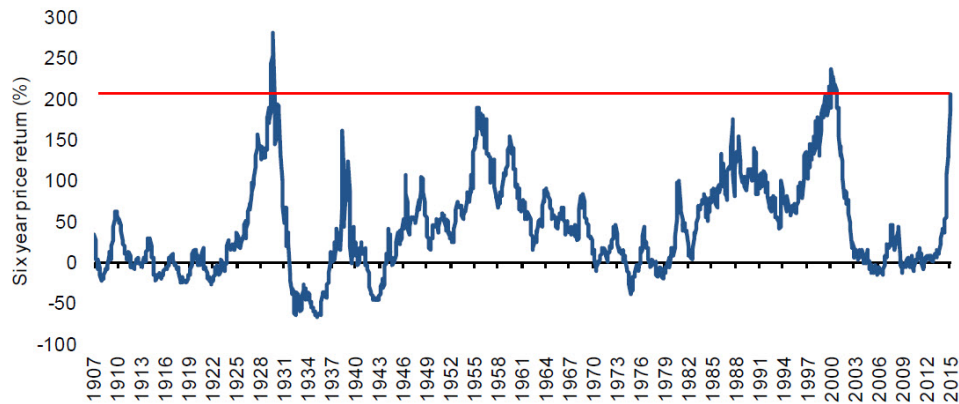
So, what do we expect of our performance (relative or absolute) over the remainder of 2015 – and into the near future? Truthfully, your guess is as good as ours. We are not dodging the question. Short-term market (portfolio) forecasts are simply too random. As a sage once said, *"...short term market forecasts tell you more about the forecaster, than their forecast."*

That dodge aside, we will state unequivocally, that our current portfolio's "risk/reward" is currently quite attractive. More specifically, the key fundamental attributes of our current portfolio of invested companies (both return on assets and prospective earnings growth rates) are collectively higher than both our benchmark and the S&P 500 Index – *and* our portfolio's twelve-month forward valuation (P/E) is now at a double-digit discount to both our benchmark and the market.

Again, it would be foolhardy of us to proffer any type of short-term market forecast or portfolio return forecast – particularly if the world’s central banks become even more ingenious to “quantitatively ease” the world’s yield curves to negative interest rates. That critical caveat aside, the current level of our portfolio’s attractive risk/reward is at levels that were brought to bear during only our worst periods of relative underperformance.

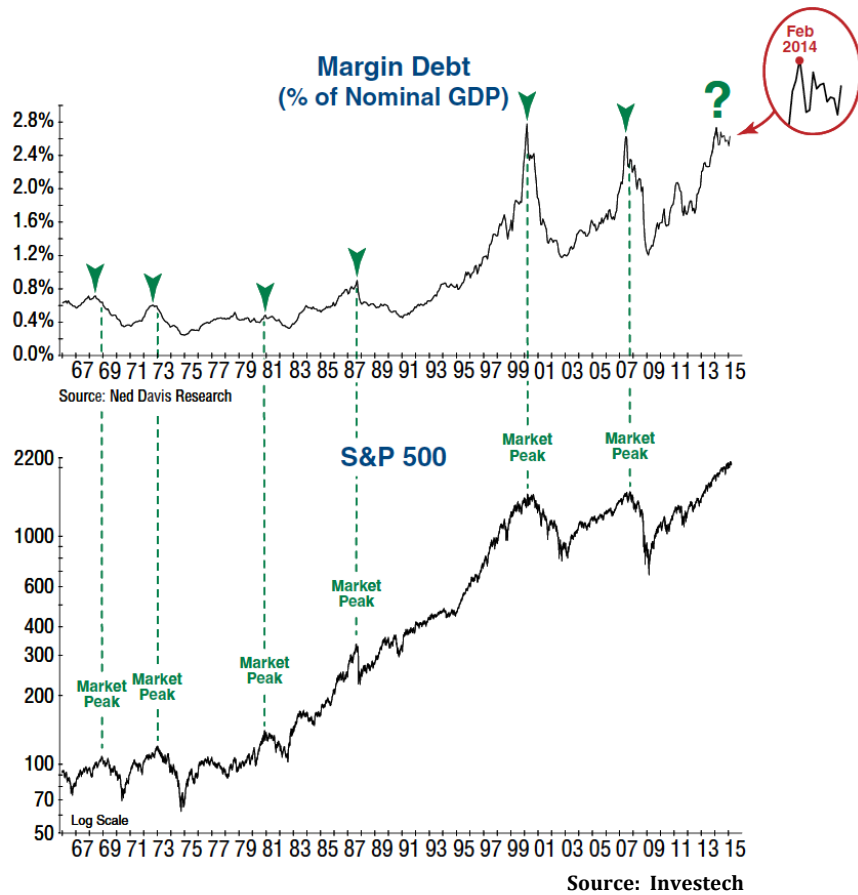
Getting back to our regularly scheduled non-stop bull market, we note that the S&P 500 Index’s tiny gain in the first quarter is the 11th positive quarter in the past 13 quarters – the Russell 3000 Index has just clocked 11 *consecutive* positive quarters in a row. Further, if not ominously, the current +200% six-year gain in the stock market is the third best since 1907 - the only other two +200% 6-year gains were 1929 and 2000 – both major bull market tops.

Six year change in the S&P 500 – the historical precedents are not reassuring

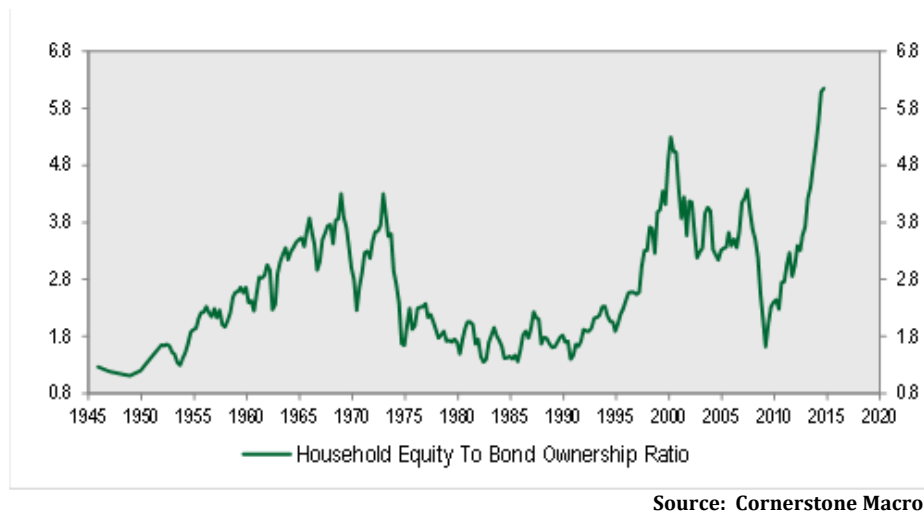


Source: Global Financial Data

Measures of margin debt are certainly flashing amber – if not red. Prior peaks in margin debt have quite accurately signaled the end of every major bull market over the past 50 years. In our view this makes imminent sense. When the last speculative bidder of stocks has played their hand, bull market greed, by definition, reaches its apogee.



Relatedly, as we have commented on in the past few of these Letters, as the chase for yield goes unfulfilled in global bond markets, the chase has been in full force in common stocks during the current bull market. John and Jane Q. Investor have never owned as much stock relative to their respective bond holdings over the past 70 years. This is quite astounding considering that the U.S. bond market (10-year) is up 140% -and has only posted two negative return years (2009 and 2013) - since 2000.

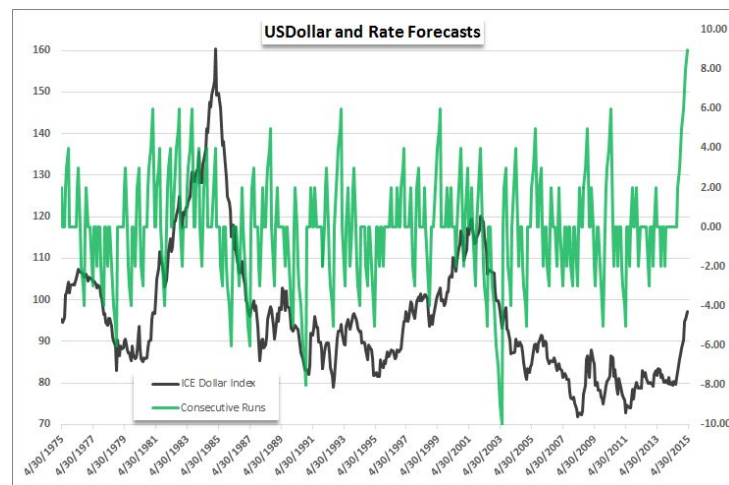


Again, the prior peaks in this ratio (1968, 1972, 2000) should be a loud and clear clarion call to reduce portfolio risk. John Hussman of the Hussman Funds recently noted that by his calculation (which we do not disagree), never before has the stock market *and* bond market been both priced to deliver little more than 2% per annum returns over a 10-year holding period. Said another way, bonds (and of course, cash) have traditionally been a safe haven when the stock market declines. Today, the 10-year Treasury Bond is a totally different total-return animal with a coupon of just 1.90%. Perhaps more ominously still, since 1928 the 10-year has only posted one double-digit negative calendar year return – just *one* in the past 87 years – in 2009 at -11.12%. The second worst calendar year return for the 10-year since 1928 was just yesteryear in 2013 at -9.10%.

Year(s)	S&P 500 Index	10-Year T-Bond	3-Month T-Bill
1973-74	-36.50%	5.72%	15.03%
1977	-6.98%	1.29%	5.13%
1981	-4.70%	8.20%	14.30%
1990	-3.06%	6.00%	7.55%
2000-02	-37.43%	41.78%	11.37%
2008	-36.55%	20.10%	1.59%

Source: www.stern.nyu.edu

Much ink (toner?) has been spilled (including far too much of our own) over the past couple of years questioning the efficacy of our nation's current monetary policy. The high priests in the temples of the Federal Reserve still profess that even after an economic expansion close to clocking in at 84 months, our economy is still so fragile, plus our stock and bond markets so sensitive to even a modicum of pain, that the galactic dose of epidural in the form of the +\$4 trillion expansion in the Fed's balance sheet must assuredly continue to flow. Today, the once gallant bond vigilantes are quiescent in the extreme. On the other hand, the currency vigilantes have entered the narrative with full force.



Source: www.stocktwits.com

The record rise in the U.S. dollar over the past nine consecutive months is beginning to call the world's high priests' bluff.



For those who may be expecting their bond holdings to be a buffer in the next rising interest rate-driven stock market bear market, consider the following bond math:

A \$100,000 face value 10-year Treasury bond with a starting coupon yield of 2.00% would fall -4.0% if rates increase just .50% over twelve months and -7.8% if rates increase 1.00%. That same bond would be worth only \$88,400 if rates would rise by 2.00% over the next two years. If, perchance, global economic events might surprisingly develop to cause the current 10-year yield of 2.00% to spike to 3.50% over the course of a year, such an outcome would render a historic loss of -11.50% in the 10-year. Little wonder Buffett recently quipped that he wouldn't own a "10-year bond, much less a 10-minute bond."

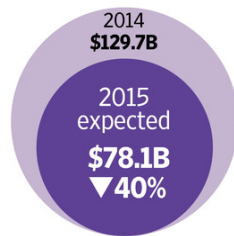
Crude Realities ... and Opportunities

The crude oil crash continued in the beginning of 2015, rendering many oil-related stocks in their own bear market. We continue to swing a fat bat at what we believe are very fat stock pitches. Our favorite energy related companies are what we consider to be the very best companies in the oil service industry – Core Labs, National Oilwell Varco and Schlumberger. In our last [Client Letter](#) we commented on these three companies. In this Letter we would like to discuss why we believe the current bear market in crude oil may be at its nadir.

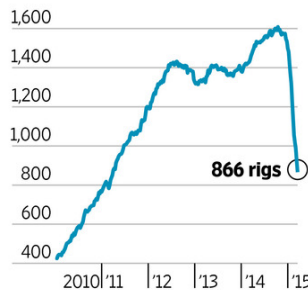
Strategic Drilling

Capital spending by energy companies and the U.S. rig count have fallen...

Capex for biggest U.S. shale firms



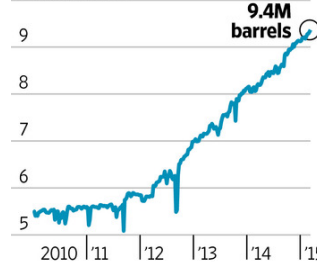
Total active oil rigs



...but U.S. production remains robust, thanks to a focus on the best fields, keeping prices down.

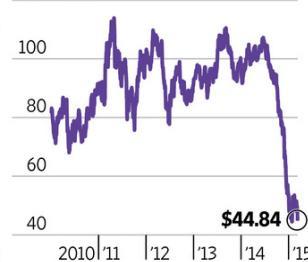
Daily oil production

10 million barrels



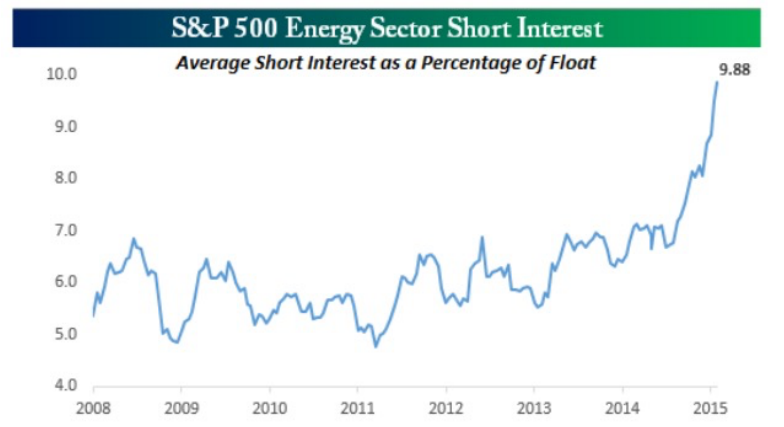
Oil price, West Texas Intermediate

\$120 a barrel



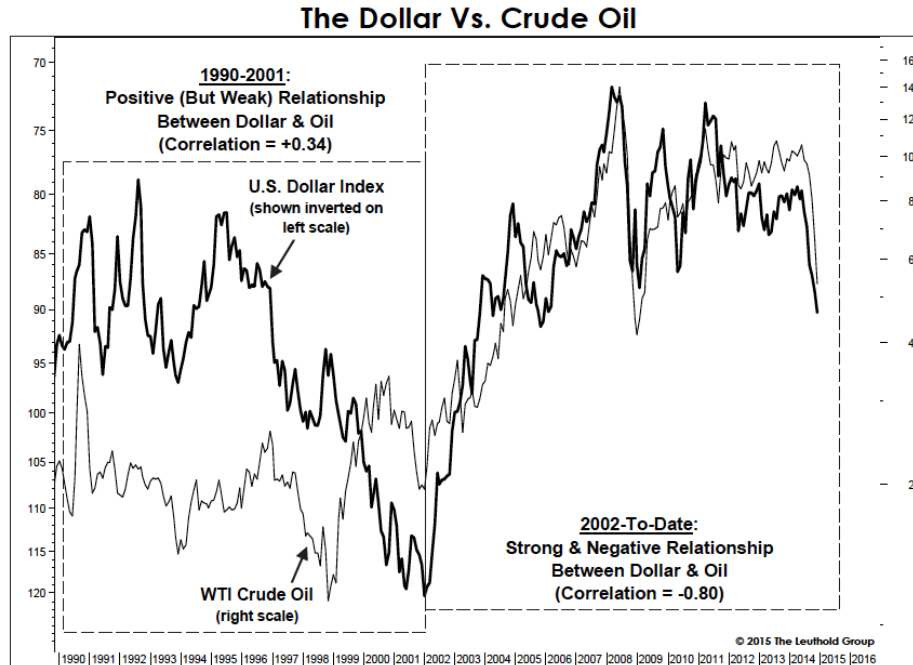
Sources: the companies (capex); Baker Hughes (rigs); Energy Information Administration (production); SIX Financial Information (price)
THE WALL STREET JOURNAL.

It's been over a decade since the last time the price of a barrel of crude oil fell three consecutive quarters. The industry has wasted little time in adjusting to the new environment. The Baker Hughes U.S. rig count last peaked at 1,900 back in the fall of 2014. As of this writing in early April, the rig count has swiftly been nearly cut in half to 1,028. Wall Street has acted swiftly as well. Earnings estimates have been slashed. Most energy-related stocks have been in sharp bear markets. The bears are out in full force.



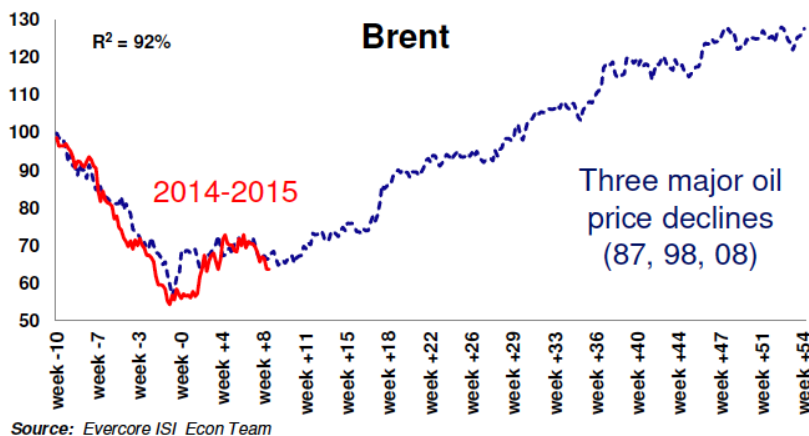
Source: Bespoke

The trifecta blow of avowed market share gains from Saudi Arabia, plus the recent 10-week gain of 76.3 million barrel increase in U.S. crude inventories (a +30-year record), as well as the significant negative correlation of gains in the U.S. dollar and the concomitant decline in the price of crude has conspired to cause one of the worst declines in crude oil on record.



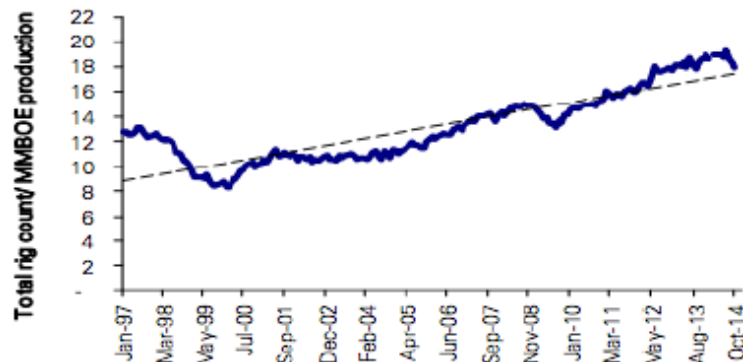
We have seen full well the powerful, self-correcting, mean-reverting process of unsustainably high crude oil prices last June when the spot price of West Texas Intermediate (WTI) oil hit \$108 (Brent \$115). We believe we are in the midst of the same mean-reversion for unsustainably low oil prices.

History Supports Our View That The Oil Market is Bottoming



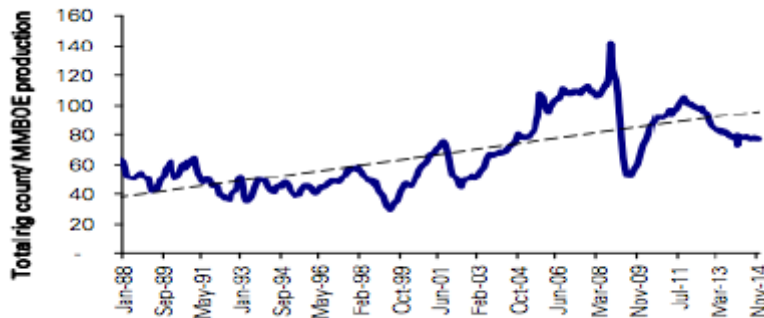
In our opinion, the most underrated, least-remarked (and quite bullish) structural attribute of the oil service industry is drilling intensity. The increasing age and steady depletion of the world's found oil and gas reserves is a "demographic" reality that should serve as a multi-decade tailwind for the oil service industry. In addition, discovery sizes are smaller, conventional fields are more difficult to scale, plus the remarkable ascendancy of unconventional shale all service to drive oil service intensity. If international drilling intensity follows the course of drilling intensity in the U.S., then the increased international exposure of our three invested oil service companies should be bountiful.

Figure 3: International drilling intensity (1997- present)



Source: US EIA, Baker Hughes, Deutsche Bank

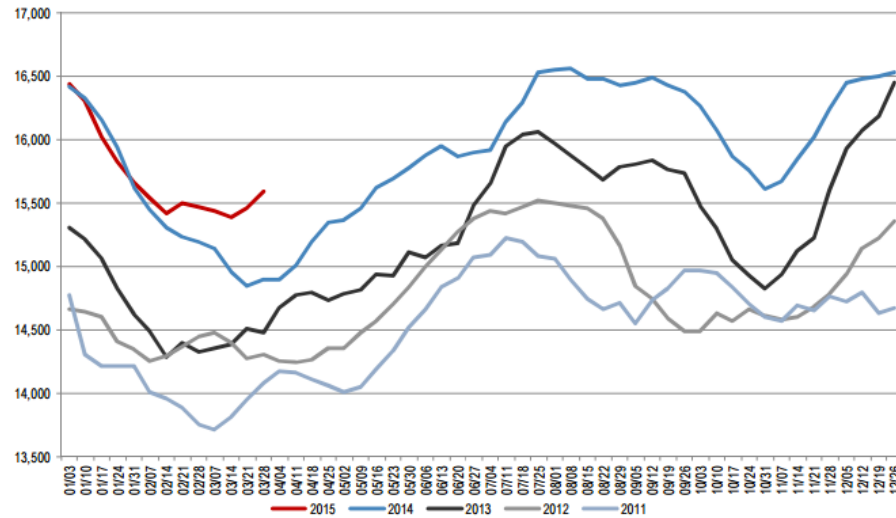
Figure 2: US drilling intensity (1987 - present)



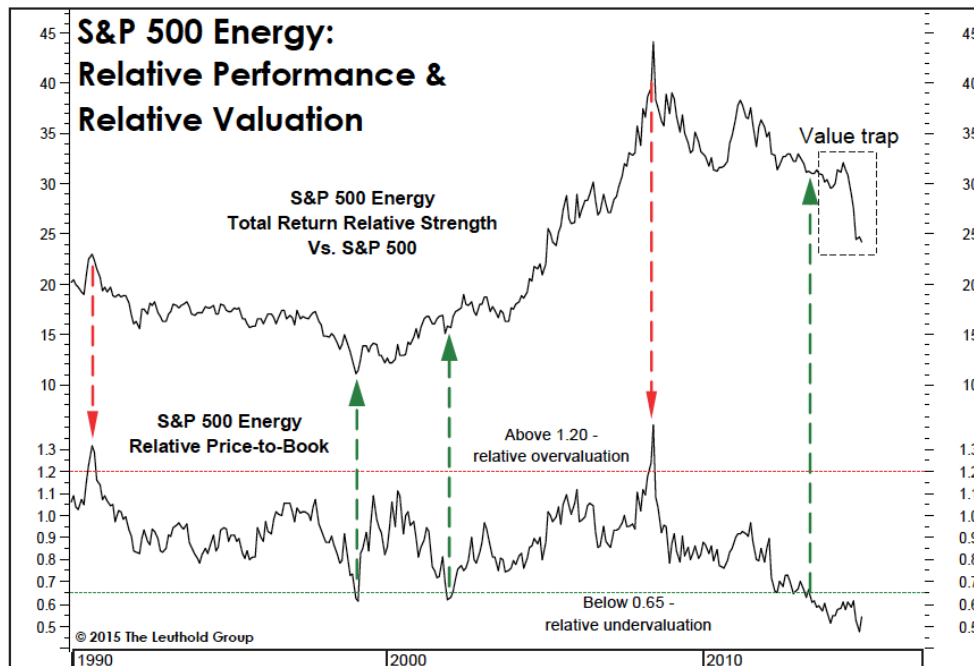
Source: US EIA, Baker Hughes, Deutsche Bank

Additionally, demand trends have been positive. On a secular basis, implied demand as measured by the EIA is up almost 5% so far YTD in the US. From a seasonal standpoint, the end of refinery turnarounds and the beginning of the summer driving season should drive an incremental 1mm barrels of demand over the next two months. That more than anything should drive inventory from persistent builds to (modest) drawdowns.

Figure 6: US Crude Oil Demand Data

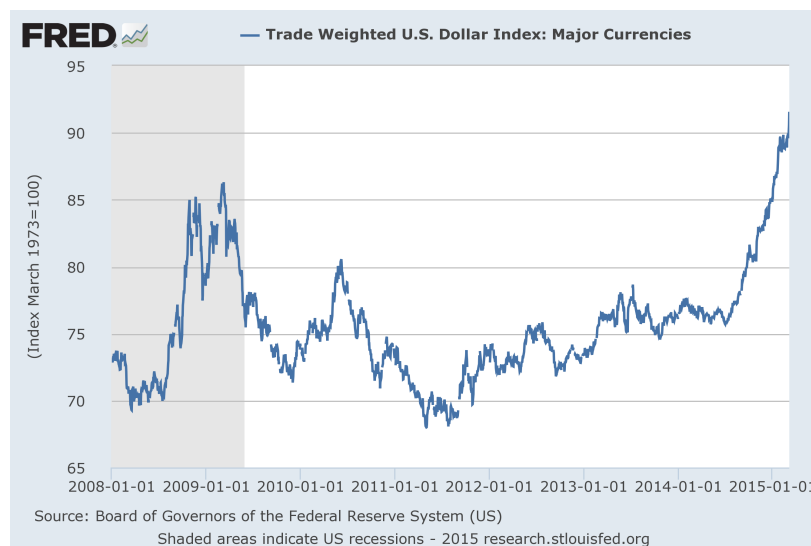


Our fat-bat investment in the shares of Core Labs, National Oilwell Varco and Schlumberger are not a speculative bet on the future price of crude, but rather, a thoughtfully reasoned, long-term investment in what we consider to be the very best businesses in the oil industry – at what we believe to be unusually attractive valuations.



Investment Process

The macroeconomic environment has little or no quarter in our investment process. However, we would be remiss not to address some of the more pronounced macro headwinds (and tailwinds), as dictated by the frequency with which our portfolio of companies address them on conference calls and/or in public filings. For example, over the past few quarters, several of our companies have discussed the effects of the recent appreciation of the U.S. dollar, particularly as the US Dollar Index has rallied nearly 25% in less than 9 months (from June 30th 2014 through mid-March 2015). We have to rewind the clock over 30 years, to late 1980 and early 1981, in order to find a similar trajectory of dollar appreciation (though, the summer of 2008 comes close).



But rather than debate how and why currencies gyrate, our philosophy and process requires that we instead focus on investing in only those businesses that we believe have sustainable competitive advantages, evidenced by peer-leading profitability. While our businesses' profitability might face currency headwinds over the near-term, we think the long-term competitive effects will be negligible. For one, similar to currencies, competition is relative, and most of our companies' competitors face similar currency headwinds. Further, several of our companies enjoy pricing power to help offset the dampening effects of a strong home currency. Again, this is not to say the profitability of our companies will not face near-term headwinds – there is a good chance they will, per their guidance – but we think the competitive positioning of our businesses will enable them to offset some of the effects of a stronger Dollar through various cost containment efforts, natural hedging via international scale and also by raising prices.

As it stands, we are skeptical that the rapid rise of the dollar has compromised the competitive advantages of our companies particularly because our businesses have core value propositions that are difficult to copy, regardless of currency. For

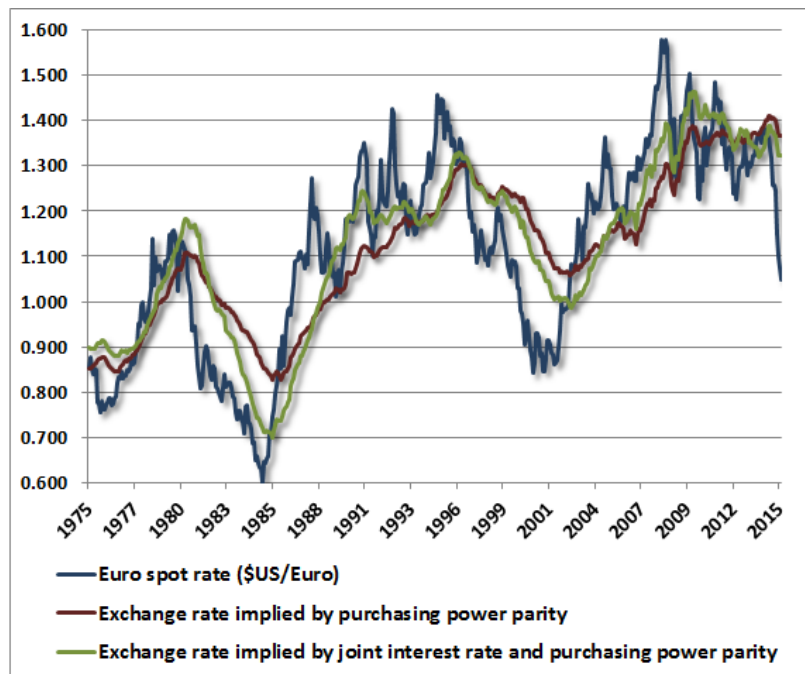
example, while LKQ Corp recently announced a disappointing outlook with slower than expected earnings growth for 2015, a meaningful component of this shortfall was attributed to currency headwinds. However, we think currency's longer-term effect on LKQ's profitability will be negligible as LKQ's value-added in distribution stems primarily from their unrivaled scale. Through rapid consolidation and reinvestment over the past few years, the European business at LKQ has grown to over \$1.8 billion in revenues (over 25% of consolidated revenues) through the end of 2014; as recent as 2010, LKQ had no revenues outside of North America. This reinvestment has vaulted the Company into position as the largest distributor of automotive aftermarket parts in the United Kingdom, as well as one of the largest in Europe. With this scale, LKQ competes differently by eliminating various middlemen ubiquitous to the "three-step" distribution channel of the mechanical and collision parts market in Europe. LKQ intends to remove a "step" from the distribution process and then pocket the margin for shareholders. Stateside, we expect LKQ to incrementally lower its cost structure, given that management expects to face less competition from exporters when bidding on inventory in the salvage market. The effects of these cost benefits will certainly lag the recent, rapid rise in the Dollar, but we expect it to have some effect as markets adjust to the dollar's new levels. So while LKQ faces material currency headwinds for the first time in its corporate history, we believe that over the next few years, LKQ's aggressive reinvestment in its international business, along with "natural hedging" from its US business, will yield profit share-take that will more than offset recent currency headwinds.

Another Company that has faced notable currency headwinds over the past few quarters is the Priceline Group. Priceline is the proprietor of several international online-travel agency brands, including booking.com, priceline.com, agoda.com and KAYAK. According to management, over 90% of Priceline's business goes through one of their international brands, with a significant majority of that business transacted in non-US currencies. In spite of this, Priceline continues to reinforce its competitive positioning, particularly with respect to increasing customer mind share and scale in international lodging supply. Witness, over the past three calendar years, the Company spent approximately \$5.4 billion on online advertising, which is a colossal amount on an absolute basis and also relative to peers. While online advertising expenses have been maintained at about half of Priceline's total operating expenses, gross profits have grown over 150%. Expedia is one of Priceline's most prominent competitors, yet its entire advertising budget was a third less than Priceline's online ad budget, meanwhile Expedia's gross profit grew less than half as fast. Further supporting Priceline's mindshare moat is over 600,000 lodging properties listed on its flagship site, booking.com. The vast majority of booking.com's listed properties are located internationally, a tally we estimate is at least 50% larger than what Expedia offers. Finally, Priceline naturally pays most of its expenses in the local currency where revenue is generated, effectively "hedging" profitability. So while the translational effects of Priceline's international profits will create near-term headwinds to earnings estimates, we believe that the competitive

positioning and reinvestment opportunity for the Company is still very robust and should far outstrip future declines in currencies.

Another mechanism for offsetting currency headwinds is by raising prices for products and services in the country with the relatively weaker currency. A recent example is Apple's alleged price increases in Russia and Japan, as the ruble and yen have lost significant amounts of value relative to the dollar. iPhones and iPads are supposedly 10% to 30% more expensive for Japanese and Russian consumers, when compared to the past 12 to 24 months, as Apple serves up the inflation that so many central bankers seem to be begging for. We believe that Apple's pricing power is a by-product of their superior value propositions and competitive positioning and should be sustained in the face of any further currency volatility.

In conclusion, while it is likely that near-term earnings estimates will be reduced for our multi-national businesses due to a dramatic increase in the dollar, we believe that such movements are not sustainable over a multi-year horizon. For instance, we do not expect the U.S. Dollar to appreciate 25% per annum, over the next three to five years. Indeed, currencies (see below), much like stocks, bonds and real estate can over and under shoot "fair" or "intrinsic" value. As such, we consider the recent currency headwinds to be transient compared to the long-term reinvestment and growth opportunities of our companies. We attribute this conviction to the relatively unchanged, superior competitive positioning of our businesses.

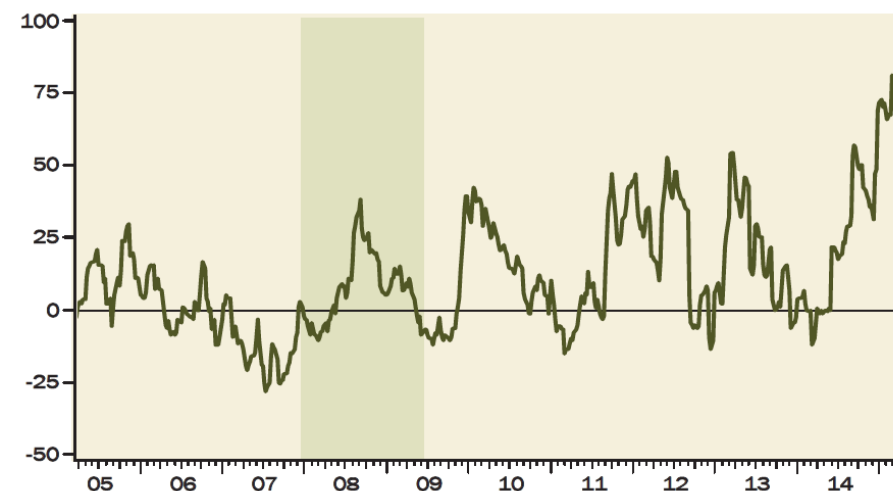


Source: Hussman Funds

CHART 2: NET SPECULATIVE LONG POSITION ON THE USD

United States: Intercontinental Exchange

(thousands of contracts; >0 denotes net long)



Shaded region represents a period of U.S. recession

Source: Haver Analytics, Gluskin Sheff

Company Commentaries

National Oilwell Varco

National Oilwell Varco (NOV) was the biggest detractor from the portfolio's performance during the quarter. As oil prices continued to decline during the quarter (albeit, with recent signs of bottoming), E&P capital expenditure budgets have been slashed across the globe. Currently, credible estimates for upstream spending in the energy sector are for a fall of 10-15% internationally with a blood-curdling decline of 40-50% in North America, during calendar 2015. Further, E&P's newfound austerity on the demand side (both national and international) have helped exacerbate a cyclical, oversupply of offshore rigs that began in early 2014. As such, NOV faces some stiff headwinds, particularly with respect to its crown jewels, Rig Systems and Rig Aftermarket businesses. We say "crown-jewels" because when it comes to designing and manufacturing drilling equipment, particularly to be outfitted on offshore rigs, NOV has upwards of 80% market share. As we've chronicled in past, we attribute this dominant position to NOV's aggressive acquisition strategy over the past few decades, which included more than a few boom-bust cycles.

In addition, NOV's formidable profitability has turned its balance sheet into a veritable Rock of Gibraltar, with nearly \$9 billion in net short-term assets and about \$3 billion in long-term debt. NOV's 2014 EBITDA was about \$4.5 billion on a market

cap that is hovering around \$20 billion, as of this writing. As such, the stock is trading at just 3 to 4 times trailing enterprise value to EBITDA, per share. Now, we pay little attention to trailing multiples, but a “low-single-digit” multiple at least begs to be “unpacked” via a discounted cash flow model to see just how much (or little) risk is embedded in future earnings growth estimates. Sparing you the gory input details, we surmise that the market is embedding a roughly 2/3rds decline in NOV’s EBITDA per share, and then maintains that base ***in perpetuity***. Of course, given that we are growth investors, if we believed a perpetual 2/3rds decline in earnings to be a modestly probable scenario, then we would not currently own NOV, nor would we have added to it during the quarter. As it stands, we believe an extraordinary buyback of NOV shares would be extraordinarily accretive to shareholders, with the benefits more than offsetting near-term, cyclical earnings headwinds. So while we do not know when oil bottoms, we believe that NOV’s competitive position remains unassailable, which should drive the Company to survive and thrive in the current cycle, all the while sporting a stock that is notably “de-risked” with attractive upside.

Core Laboratories

Core Laboratories (CLB) was also a notable detractor to performance during the quarter. Core provides services and, to a lesser extent, equipment to national and international petroleum exploration and production companies. Many of Core Labs’ services include providing “mission-critical” reservoir data to their E&P customers. Accordingly, CLB is deeply embedded in E&P production budgets. For example, while international E&P spending is estimated to fall 10% to 15% during 2015, Core’s management expects that the Company’s Reservoir Description revenues will be down only 3% to 5%.

However, while a majority of Core’s revenues are related to services, around a quarter of the Company’s revenues come from selling highly specialized equipment, particularly related to well-completion efforts. We consider Core’s equipment business to be more cyclical than the rest, but still very valuable given that Core’s equipment typically commands premium pricing to compensate for its highly sophisticated applications. In addition, Core’s equipment business, while highly profitable, is less cash efficient than services, if only because of the need to carry inventory. For example, as demand for Core’s equipment started falling during the fourth calendar quarter of 2014, the Company converted over 130% of net income into free cash flow and the Company expects free cash flow to come in at a level 20-30% higher than net income over the next quarter. In the prior 12 quarters, CLB was converting net income into free cash flow on a nearly 1 to 1 basis. So as the more cyclical elements of Core’s business are pressured, the Company naturally becomes more cash flow efficient, which we think bodes well for reinvestment opportunities in the face of weakening competitors, as well as enhanced shareholder returns.

On the latter score, during the quarter management boosted the Company's annualized dividend by 10% and also continues to repurchase shares at what we believe are attractive historical valuations.

All told, we think Core Labs' best-in-class profitability is well insulated by a deep and difficult-to-replicate historical data collection effort. As the current upstream oil and gas cycle ebbs and flows, we suspect that Core will continue to take budget share as the development of the marginal hydrocarbon inevitably becomes more important and profitable.

Coach

Much of our writing on Coach (COH) in the last year involved defending our position in the name and explaining to our clients why we continued to hold it in the portfolio as the Company has admittedly had quite a rough spell of performance throughout the past few years. Refreshingly, Coach was one of the larger contributors to the portfolio's performance during the quarter as the Company had a fair share of note-worthy events. While this does excite us, we also acknowledge the reinvestment journey has been long and will continue to take patience, with elevated expenditures over the next 18 months as the Company continues the remodel of existing stores into its new concept, among other brand-boosting initiatives. Most importantly, though, we are seeing nascent signs that the aggressive reinvestment campaign Coach endeavored upon approximately a year ago is paying off.

Early in the quarter, the Company announced the acquisition of Stuart Weitzman which will expand on Coach's existing premium footwear business with significant potential for both domestic and international growth. Over the last five years, Stuart Weitzman's considerable brand cachet has helped revenue to a 10% compounded annualized growth rate. Coach management indicates the Stuart Weitzman deal will be immediately accretive to earnings, upon closing. In addition, Coach presented its third seasonal and first "full-size" (aka presented via runway) collection at New York Fashion Week. Creative Director, Stuart Vevers, looks to be making quite the impression, as the company is still fairly new in this Ready-to-Wear (RTW) space. Of course, RTW is a lower margin business relative to accessories, but we think it will remain less of a revenue driver and more of a boosting element to the Brand's credibility. For example, Company-reported social impressions increased more than 30% from the spring collection just six months prior, along with a roundly positive response from the fashion community. Just 24 months ago, Coach had yet to participate at New York Fashion Week in Brand history (over 70 years). This combination of RTW items and Vevers' new accessory designs are yielding very positive brand awareness, which we think is a critical element for the Company to compound at double-digits over the next few years.

As we have noted in the past, several of Coach's peers had ramped up their competitive inroads, but those look to be waning, at least, in the eyes of the market (for what that's worth). Since Coach's investor day in mid June of last year, the stock has meaningfully outperformed the S&P 500, and dramatically outperformed peers Kate Spade and Michael Kors.

We expect Coach will maintain its laser-like focus on reinvigorating the brand, reducing the number of promotional impressions and ultimately redefine themselves as a "Modern Luxury Lifestyle Brand."

Qualcomm

Qualcomm has been a material underperformer (as of this writing) over the past twelve months. Qualcomm's stock has declined about -15%, while the S&P 500 Index is up +13% and the NASDAQ Composite Index is up +24%. Worse still, over the past 36 months, Qualcomm's stock is flat, while the S&P 500 and NASDAQ have gained a sharp +50% and +58%, respectively. So why then do we still own this stock, much less have it positioned as our *largest* portfolio holding? In our view, the stock is really cheap and the Company is still a true growth company. While there is no doubt that Qualcomm's competitive advantages in both their ultra-lucrative licensing and semiconductor businesses are under attack, yet, at current valuations we believe that the market has priced in nearly zero growth for the Company for the next +5 years. Said another way, at current valuations, Qualcomm is a permanently impaired, no-growth company – in the same vein as Apple in the spring of 2013 and Coach in the summer of 2014 (both of which have rebounded smartly since their "dead-growth company" days).

As the mobile world moved from 3G technology to next generation LTE technology, the Company's technological iron grip in 3G will be less so in LTE. The Company is facing lower royalty rates in their licensing division (29% of revenues, but over 60% of operating earnings) and increased competitive pressures in their chip division – in both baseband modems and processors. The Company sources approximately 84% of its revenues from Asia (and half of this from China). That's the good news - and bad news. The Company's dominance in the region is being challenged on the royalty front by Chinese smartphone OEMs who imbed the Company's patented technology in their respective products, yet in turn refuse to pay Qualcomm their just due in royalties. The Company estimates that the unreported device shipments amount to as much as 16% of its 2014 3G/LTE global device shipments. The Company continues their *Waiting for Godot* legal resolution with the offending Chinese manufacturers. Ultimate resolution may have to wait until these bandit manufacturers seek to sell their illegal wares outside of China. The Company did reach a resolution on a related anti-trust lawsuit with China to the tune of \$975 million. On the semiconductor front, the Company was challenged again by both Asian competitors (Mediatek) and customers (Samsung's in-house chips), plus here

in the U.S. as Intel seems willing to pursue profitless prosperity with their late-to-the-game mobile chip technology.

Despite this litany of woe, the Company is still a cash-flow machine. The Company continues to generate cash flow margins (Free Cash Flow/Sales) at a gushing rate of 27%. Their cash pile has grown so large, and the balance sheet so under levered, that the Company recently announced a new \$10 billion stock buyback authorization and a 14% dividend increase. The Company expects to complete this (plus \$2 billion remaining on the current authorization) over the next twelve months. At the currently depressed valuation, \$12 billion in retired shares should be quite accretive to earnings per share growth. The debt financing should be cheap enough still that the interest payments could be entirely offset by reduced dividend payments. All told, we believe that much of the bad news of late at Qualcomm is more than discounted in the current valuation. A dividend yield of 3% (stock at \$64) would serve to buttress an already favorable risk/reward in these shares.

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