**Wedgewood Partners 4th Quarter 2014 Client Letter**

**2015: Groundhog Day or Wizard of Oz?**


## Review and Outlook

Our Composite (net-of-fees) gained +5.21% during the fourth quarter of 2014. This gain is in line with both the gains in the Standard & Poor's 500 Index of +4.93% and the gain of +4.78% in the Russell 1000 Growth Index. The fourth quarter was the eighth quarter in a row of positive gains in the S&P 500 Index, and 9 out of the past 10. The last negative quarter in the stock market was back in the fourth quarter of 2012. That decline was just -.38%. The S&P 500 Index did decline during the second quarter in 2012, but only a piddling decline of -2.75%. The last meaningful quarterly decline in the stock market was registered in the third quarter of 2011 when the S&P 500 Index fell nearly -14%. Said another way, the U.S. stock market has been straight up for 13 quarters – a streak nearly unmatched in the annals of stock market history. In addition, as if the tripling in the S&P 500 Index during the Great Bull Market was not enough for investors, the gain in average (or "median") stock (Value Line Arithmetic Index) has been more than *+75%* greater than the capitalization-weighted S&P 500 – or nearly *five-fold* over the course of the Great

Bull Market. (See chart of P/CF of median stock on top of page 10.) Lastly, as this Letter is being written, Mr. Market has awoken from his 2014-volatility slumber. According to *Investech*, there were only 32 days in 2014 with daily moves of 1% - and only a single trading with a 2% move. As sober reminder, 2008 had 72 2% days and 2009 had 45.

Mr. Market did however serve up a minor correction during the past fourth quarter, but Mr. Wizard of Oz-Fed made sure that the -10% decline was both short-lived - and reversed in short order. Recall that in our last Letter we welcomed the decline in October and had hoped that it would last long enough for us to grab some long-awaited bargains. We wrote last October 15, *"…our investment-process pencils are fully sharpened as such emerging opportunities hopefully become fatter pitches."* However, investors have come to learn (far too many in Palovian fashion, in our opinion) that the Federal Reserve will not, by policy dictate, abide deflation, abide unemployment rates over 6% – and abide any double-digit declines in the stock market. Alas, the very next day, on the 16th, the St. Louis Fed President James Bullard promised to spike the Fed's already historic-sized punch bowl-balance sheet with these market-moving comments:

**October 9th**

***"When there is a mismatch between what the central bank is thinking and the market is thinking, that sometimes doesn't end well, because there can be a surprise later on."***

***"The markets are making a mistake" and expect the Fed to maintain its ultra-easy policy stance longer than Fed officials themselves currently expect. When it comes to these expectations I would prefer that those be better aligned than they are."***

***"We should act on good news. We've got a pretty good performing economy. We should be willing to remove some accommodation. "It would be better to get this process started and not wait too long,"***

**October 16th**

***"U.S. macroeconomic fundamentals remain strong" and his forecast for 3% annualized growth in the second half of 2014?remains intact."***

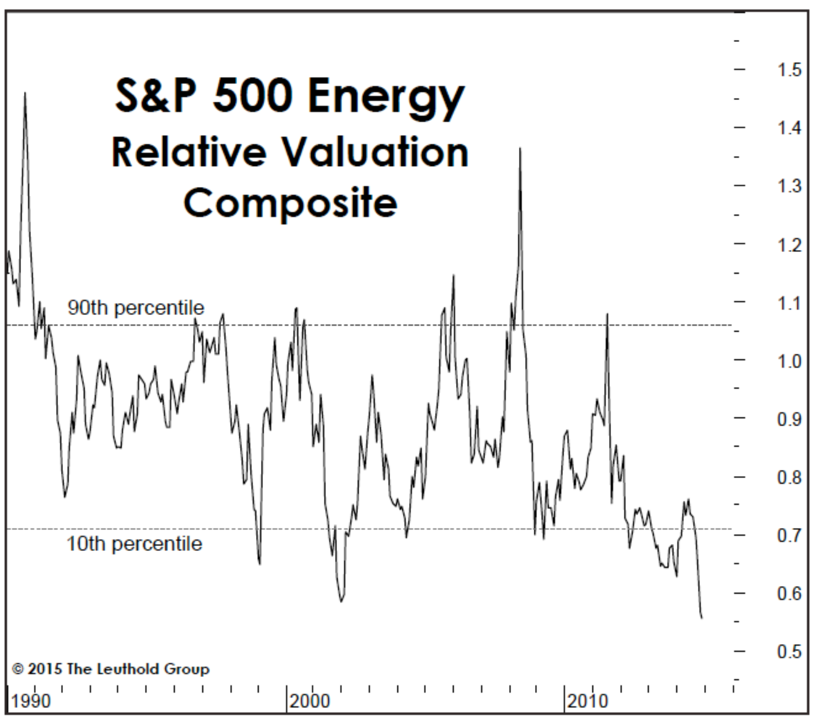
***"Inflation expectations are dropping in the U.S., and that is something that a central bank cannot abide,"***

***"We could just end the program in December. But if the market's right and this is portending something more serious for the U.S. economy, then the committee would have an option of ramping up QE at that point."***

Since Bullard's comments on October 16, the S&P 500 has rapidly gained nearly +14% by the end of December. Fed full-valuation policy mission accomplished.

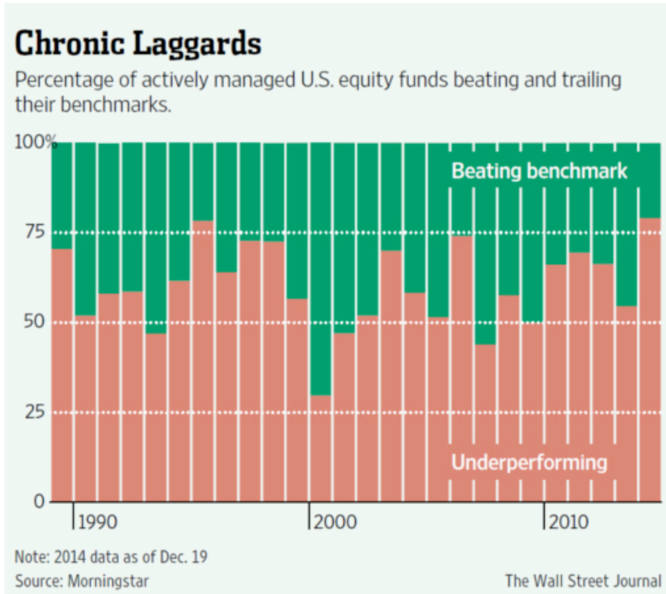
Our worst performers during the fourth quarter were Schlumberger, National Oilwell Varco and Google. Our best performers during the quarter were Visa, Cognizant Technology and Express Scripts.

During the quarter we trimmed positions in Apple, Perrigo and Berkshire Hathaway due to valuation. We also trimmed EMC, as the company's growth prospects are not robust enough to warrant a higher portfolio weighting. We added to our position of Qualcomm in the quarter on improved prospective risk-reward on respective share-price declines. Core Laboratories was a new addition to the portfolio during the quarter. Core Labs is an oil service company specializing in core and fluids analysis of oil fields. Given the pull back in the energy sector during the quarter, we saw all of our energy names trade down in sympathy. This not only allowed us the buying opportunity of Core Labs that we have been waiting for since we started following the Company in 2011, but it also allowed us to increase our existing positions in National-Oilwell Varco and Schlumberger, as we fully expect these oil service companies to sustain their competitive advantage during the current turbulence in the oil market - and maintain their respective long term growth and profitability we expect to see in our businesses.




Equally-weighted composites of Energy sector's Relative Normalized P/E, Relative Price-to-Book and Relative Price/Cash Flow ratios vs. the S&P 500.

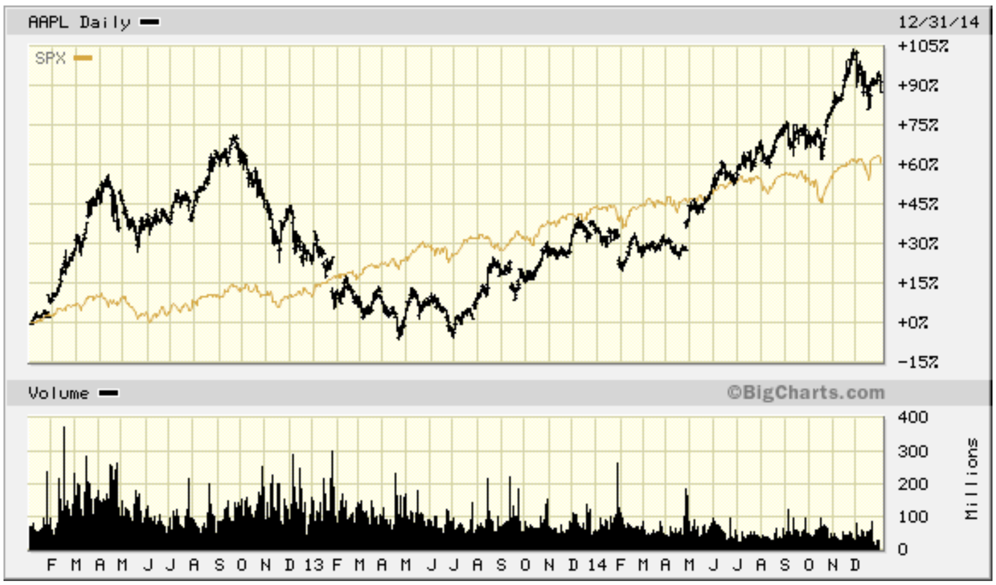
For the full year, our Composite gain of +9.2% has meaningfully lagged the gains in the Standard & Poor's 500 Index and the Russell 1000 Growth Index of +13.7% and +13.1%, respectively. 2014 was one of the worst years for active equity managers in the past 25 years. If active managers did not own a meaningful weighting in sectors such as Utilities, Healthcare (particularly biotech and specialty pharmaceutical) or Real Estate stocks, then 2014 was a slog at best.




According to Morningstar, six out of their eleven broad-based stock sectors failed to gain at least 10% in 2014. Two of those sectors, Basic Materials and Energy stocks posted negative returns. Energy deserves special recognition. On the heels of one of the steepest declines in crude and natural gas prices in decades, Oil and Gas exploration and production, plus equipment and services stocks declined by double-digits. Oil and Gas drilling stocks fell by nearly -50%. The decline in energy stocks was so great (and welcomed!) that we increased our holdings and weightings in this sector late in the quarter (more on this later in the Letter).

For the full year we had six stocks post negative returns: Coach, National Oilwell Varco, Google, Schlumberger, Verisk Analytics and Priceline. With the exception of Coach, all of these stocks had solid, if not out-sized gains in 2013, so we were not terribly surprised by their lackluster 2014 showing. And many of these were our biggest performers in 2013 (PCLN, GOOG, SLB and VRSK), necessitating the trimming of all but Schlumberger over the course of 2013. Our best performers in 2014 included Apple, Berkshire Hathaway, Mead Johnson, Express Scripts, EMC and Visa.

Apple deserves special mention as a textbook lesson of Mr. Market's animal spirits, both of celebration and hangover over the course of the last three years. Apple was the third best performing stock in 2012, third worst performer in 2013 and our best performer in 2014. And as you can see from the chart below, Apple has handily outperformed the S&P 500 Index over a three-year stretch when the S&P was up itself *+60!* Think about how much Apple's *stock* price movements dictated the fundamental narrative of Apple the *company*. In 2012, the stock was up +55% by late that May, and would subsequently peak up +70% by mid September. Then the narrative was that Apple was omnificent and peerless – a must own stock. And it was. Then, suddenly, Apple became *Icarus*. The Company failed to beat earnings expectations for a couple of quarters and the stock collapsed -45%, by late April 2013. The new, new narrative was that the invincible Apple became a leaderless, permanently impaired busted growth company. No more innovation, no more great products, no more growth. None. Then, suddenly, Apple became *Lazarus*. Seems the Company was still a great innovator, still introduced great products, still generated great growth and cash flow. The stock soared +105% by last December.



**The Great Bull Market of 2009-2014**


Before we peer in our crystal ball for the upcoming year, a few words on the prospective risk-reward of our current portfolio is of import. The underperformance in 2014 of our portfolio versus our style benchmark and the S&P 500 Index, as well as the recent heightened market volatility (particularly in the energy sector) has served to position our current portfolio quite well, in our opinion, to weather the portend of brewing stock market storms in the year ahead. Many of you will be familiar with the table below. The three key metrics to consider are both fundamental (Projected EPS Growth and Return on Assets) and valuation (Price/Prospective Earnings).

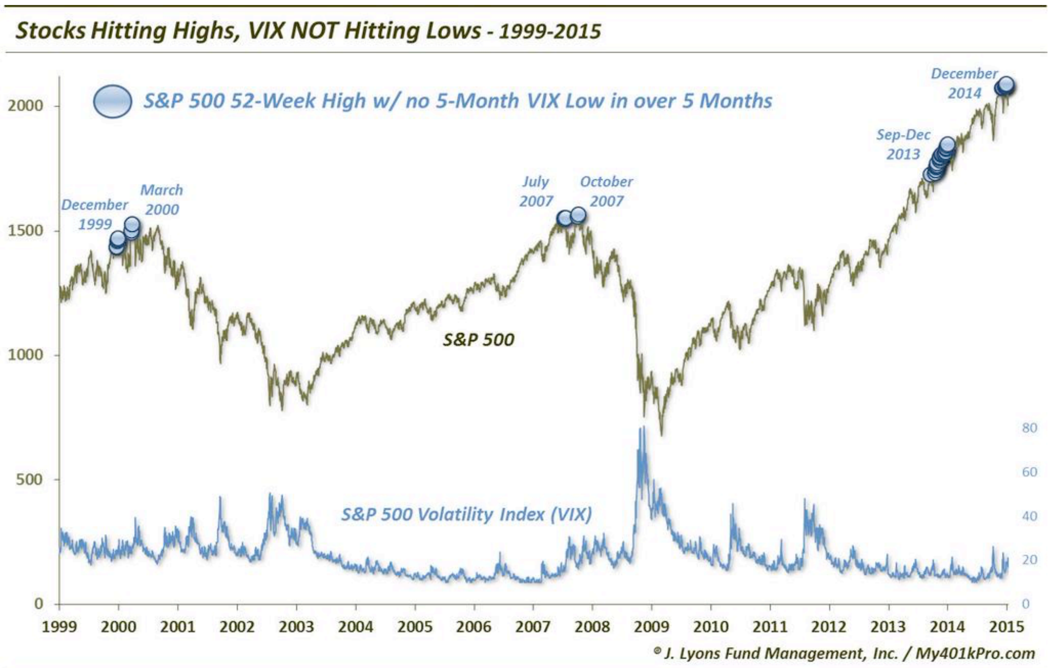
Our +22-year investment mission here at Wedgewood Partners is to build a focused portfolio of exceptionally profitable *growth* companies, but only at *value*-bargain prices. So while Mr. Market is usually reasonably efficient at pricing stocks at their fair intrinsic value, pockets of inefficiency always exist – at least, in our view, to repeatedly build a 20-stock portfolio with the demanding investment process requirements of both company growth and stock valuation. At the present, we are quite pleased that we have assembled a portfolio of companies that sport a *52% greater* Return on Assets profile versus the S&P 500 Index, but we are actually paying a -*18% discount* to the forward twelve-month P/E ratio of the S&P 500. As we like to say, *"...we like these odds."* We believe, earnestly, that such a portfolio can only be built repeatedly, because we are *focused* investors. The "edge" of focus investing, we believe is foundationally paramount to prospective investment success.

| Stock Stats \| Holdings Detail | Your Portfolio | Relative to S&P 500 | | Your Portfolio | Relative to S&P 500 |
|---|---|---|---|---|---|
| Price/Prospective Earnings | **14.82** | 0.82 | Projected EPS Growth - 5 yr % | **13.13** | 1.35 |
| Price/Book Ratio | **3.45** | 1.38 | Yield % | **1.08** | 0.62 |
| Return on Assets (ROA) | **12.66** | 1.52 | Average Market Cap $mil | **39,606.13** | 0.54 |

**Source: Morningstar, I.B.E.S.**

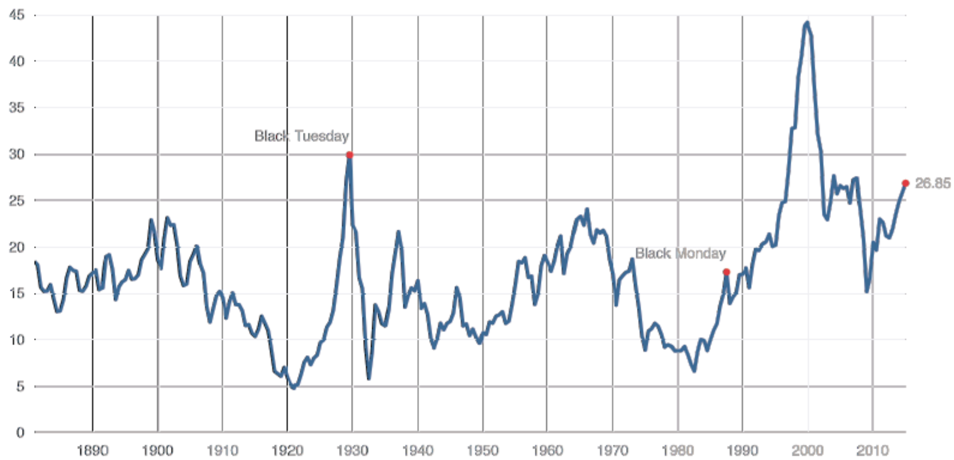
So, as we peer into our cloudy crystal ball for the portents of the stock market in 2015, our forecast (murky at best) is largely influenced by the movie Ground Hog's Day. We can easily envision a scenario much like 2012, 2013 and 2014 – another year of historically low stock price volatility, with full year double-digit gains in the broad stock market indices. This non-rigorous forecast is simply, in our view, driven not explicitly by the economic power and efficacy of the Federal Reserve's $4.5 trillion quantitatively eased expansion in the Fed's balance sheet, but rather by the implicit *faith* investors and speculators have in omnipotent central bankers to ward off the demons of unemployment – and bear markets too.


On the other hand, we can also easily envision a Wizard of Oz-like scenario that Mr. Market realizes that the central banker behind the QE-curtain is a rather impotent human being after all. All it would take in our view would be a similar market retreat like we just went through in October - with the concomitant cacophony of Tin Man investors and speculators shrieking *"Oil can, oil can!!"* If in the next such episodic market decline (and at Fed policy prescription full employment), central banker words or deeds don't deliver an immediate tonic, then one can then further envision that historically rich valuations, coupled with multi-decade high corporate margins, may just matter after all. We believe this fate is unavoidable. (The Swiss National Bank's sudden and dramatic removal on January 14 of its euro currency peg is the first such shot across the bow of financial markets.)



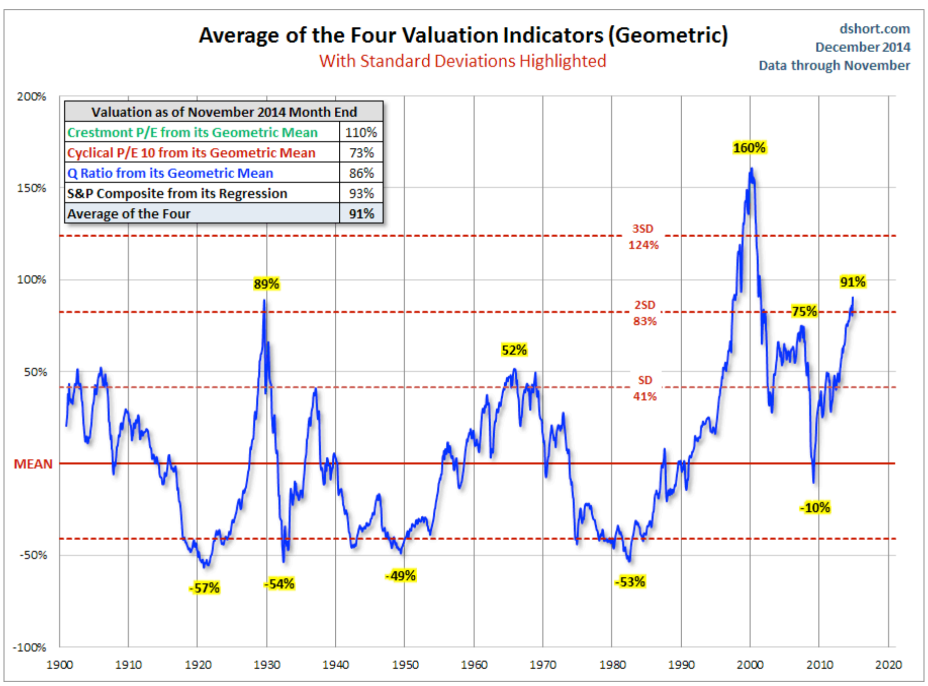

As we enter 2015 - and as the Great Bull Market nears its sixth anniversary in early March – a review of the current valuation landscape is in order. Please note, while we include neither macro market nor macro economic forecasts into our investment process, we do recognize that "reversion-to-the-mean" is a very powerful element in literally all financial markets, so we do endeavor to comment on such where we feel it is necessary. In our second quarter Letter last year, we highlighted the graphic below, of the Shiller P/E ratio. This ratio is calculated by dividing the S&P 500 Index by a measure of business cycle, smoothed earnings (10-year average of inflation-adjusted earnings). The current ratio of 27X is now at historic extremes - and is now higher than any other period save 1929, 2000 and barely 2007 highs. John Hussman, CIO at Hussman Funds, propounds that the profit margin currently embedded into the Shiller P/E is 6.7% - versus a historical norm of just 5.4%. With this adjustment considered, the *margin-adjusted* Shiller P/E of 34X is, in our view, clearly unsustainable – even in consideration of Fed-induced, zero short-term interest rates and a 10-year Treasury rate of sub 2.0%. Furthermore, while the Shiller P/E did average 40X during the months preceding the technology stock bubble 2000, Hussman postulates that the Shiller P/E was then associated with an embedded profit margin of just 5.0%. If one then adjusts for that lower embedded margin then the *margin-adjusted* Shiller P/E at the 2000 peak was 37X – not much higher than todays *margin-adjusted* Shiller P/E of 34X.

## Shiller PE Ratio

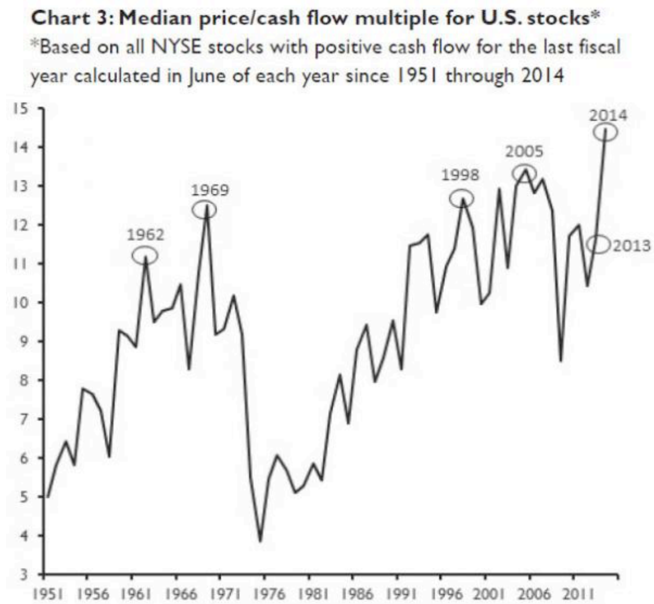



**Source: [www.multpl.com](http://www.multpl.com)**

The graphic below depicts the average of four more market valuation measures. (For those keeping score, the current average P/E is *91%* above its long-term mean, up from 84% in July.) Historically, any reading above 50% has produced future stock market returns in the low single-digits (at best), with double-digit drawdowns (again, at best) during the intervening years.

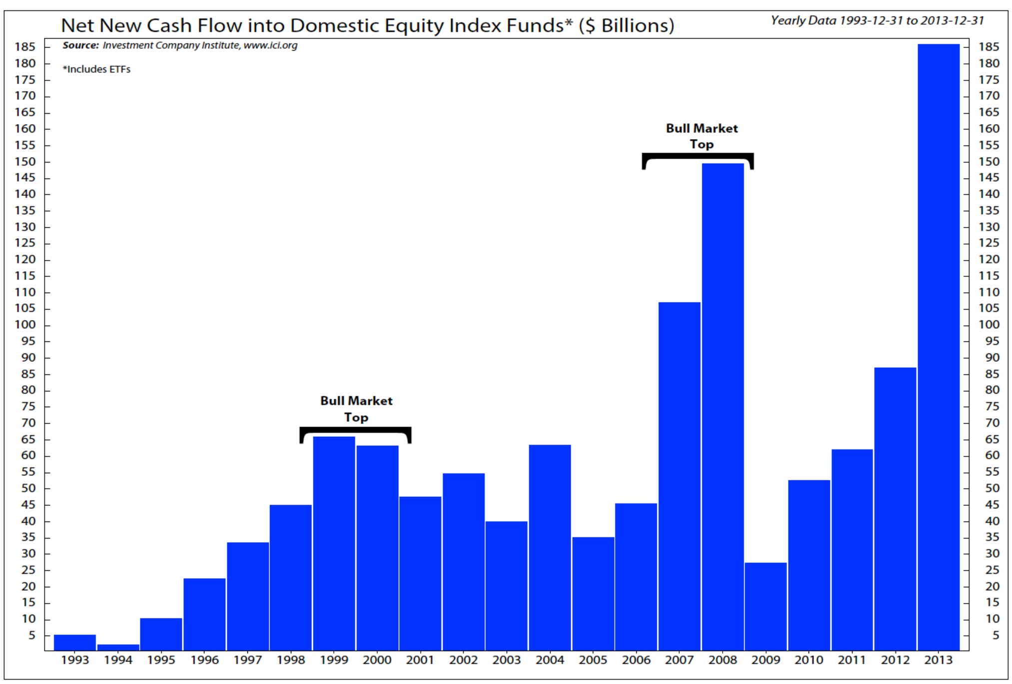



At the risk of overkill, please consider the following graphic. We have been a broken record of late here at Wedgewood in our view that the Bernanke-Yellen led Fed, plus their BFFs at the European Central Bank and Bank of Japan have collectively all been uniquely successful in creating a half decade-long monetary environment whereby the "investment pain" of holding both zero-interest bearing cash and near zero-interest bearing sovereign notes and bonds has forced investors of all stripes to the further extremes of their respective risk curves. (Average yield on 10-year U.S. and Japan Bonds and German Bunds is just 1.0%.) Again, mission accomplished.



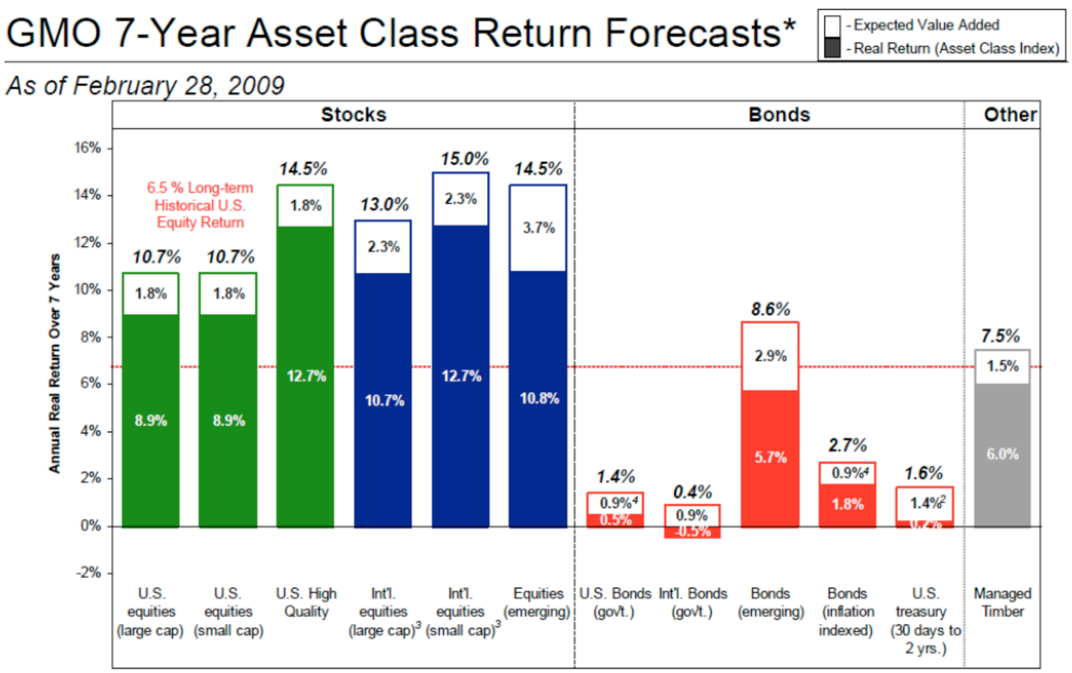

**Source: Wells Cap Management**

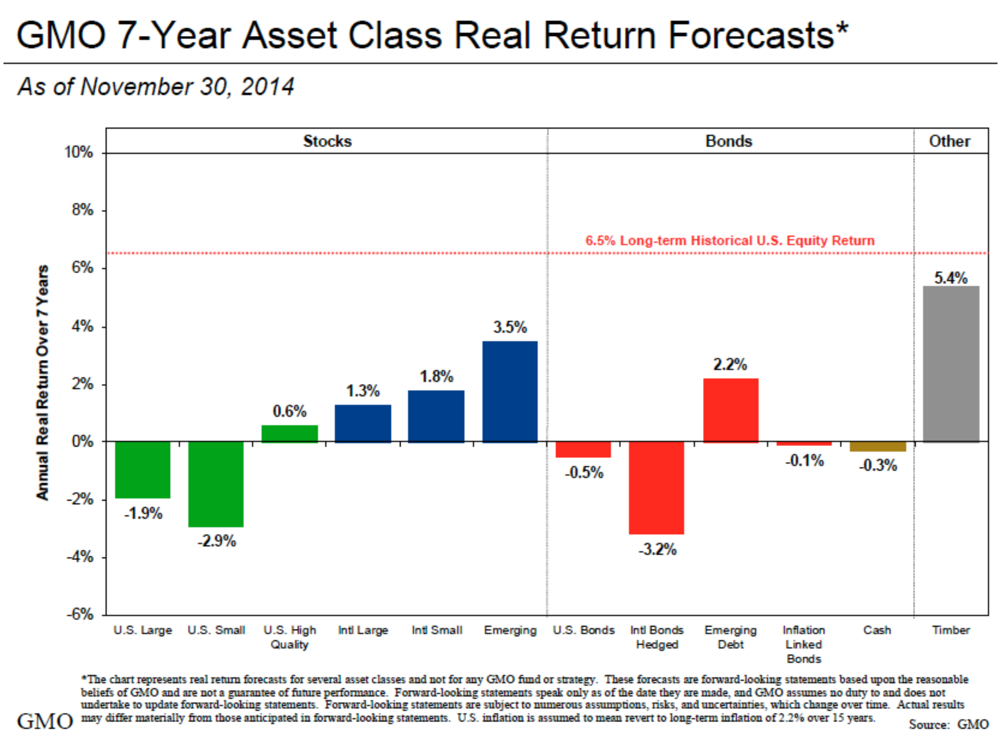
Not only are most equity investors "all in," we are witnessing, once again, a torrent of money flowing into valuation insensitive index mutual funds. According to Morningstar, in 2014 over *$165 billion* flowed into index mutual funds – while $93 billion was liquated from active investment management funds. Again, we have seen this behavior before at bull market tops.




**Source: Ned Davis Research**

We will leave you, dear reader, with two more graphics on the matter of forecasted stock market returns, both from the investment firm Grantham, Mayo, Van Otterloo. The first was published just nine days before the ultimate lows of the Great Bear Market of 2007-2009. The next dated this past November. We believe they are both sufficiently self-explanatory in depicting stock market reward – and risk.



**Investment Process**

We believe diversification is a key component for managing risk in Wedgewood's Focused Growth strategy. However, we think the virtues of diversification can be brought about in more thoughtful and effective ways, versus simply increasing the sheer number of equity holdings. We invest in only the most profitable companies that have competitive advantages protecting this profitability from industry competition. On the other hand, we are not interested in owning "also-rans." Furthermore, our profitability "snobbery" helps serve to limit the amount of business model overlap in our portfolio.

The kind folks at the various benchmark services have set investment industry standards by taking the guesswork out of diversification and defining sectors, industries, industry groups and sub-industries for most publicly traded companies. A common classification scheme we see is the "Global Industry Classification Standard," (GICS) which was developed by MSCI and Standard and Poor's, and "uses revenues as a key measure/significant factor for determining business activity"[1] to define: 10 sectors, 24 industry groups, 67 industries and 156 sub-industries![2] While we sincerely appreciate their extensive efforts to define where and how companies compete, we do not pay attention to them when executing our investment process. We are more interested in "determining business activity" by way of analyzing value propositions and the resultant profitability.

For instance, Google's GICS Economic Sector classification is "Information Technology." However, Google's public filing posits that their *"Google segment generates revenues primarily by delivering relevant, cost-effective online advertising."* We have long argued that Google is an advertiser, first and foremost. Very simply, Google's value proposition is to connect an advertiser with a relevant audience, as efficiently as possible. Google monetizes that proposition by collecting revenue from advertisers, every time some advertising-based goal has been achieved. In other words, Google's paying customers are advertisers with advertising budgets. We estimate that over 90% of Google's net revenues – or $50 billion - are advertising-based.

Let us compare Google to another long-held, "Information Technology" holding in the portfolios: Apple. Apple's value proposition is to provide a superior consumer electronic user experience. Apple monetizes that experience by developing and selling consumer electronics hardware, software and services - including the ubiquitous iPhone, iPad, Mac, iOS and iTunes platform - at a premium price.
So Apple's paying customers are consumers of Apple' electronics, willing to pay a premium for a superior user experience. That contrasts with Google's primary, value-added service, which is to aid advertisers in delivering a message to their

[1] http://www.spindices.com/documents/index-policies/methodology-gics.pdf
[2] http://www.msci.com/products/indexes/sector/gics/

targets. Both Google and Apple have distinctive value propositions, yet both companies are classified as “Info Tech.”

However, we want to reiterate that a key element of our process is that we are always looking to uncover and then manage any overlap between the *profits* of our businesses, and revenues are only one piece of the profitability puzzle. While Google and Apple customer bases are different enough, profitability overlap might exist in the form of rival, substitute and/or supplier relationships between the two companies, which presents itself further down the Income Statement (or Balance Sheet) as an expense (or liability). For example, Google has a *quasi*-supplier relationship with Apple that affects not just Google’s revenues, but also Google’s expenses. Based on our research, we believe Apple receives payment from Google when Apple devices are manufactured with Google properties included in the device’s “default” settings (e.g. the search bar of iOS Safari currently defaults to Google Search in the US). In exchange, Apple users navigate to Google properties more often than they navigate to competing properties, increasing Google’s target audience and improving Google’s value proposition to advertisers. These “Traffic Acquisition Costs” that Google books every quarter are expenses to reflect this relationship. Although Apple devices have become more ubiquitous, we believe the profitability economics of this Google-Apple "supplier" relationship still represent a low-single digit percent of Google’s profits. So while the real estate on Apple’s devices has become increasingly important to Google’s bottom-line, we believe the overlap between Apple’s profits and Google’s profits are minimal.

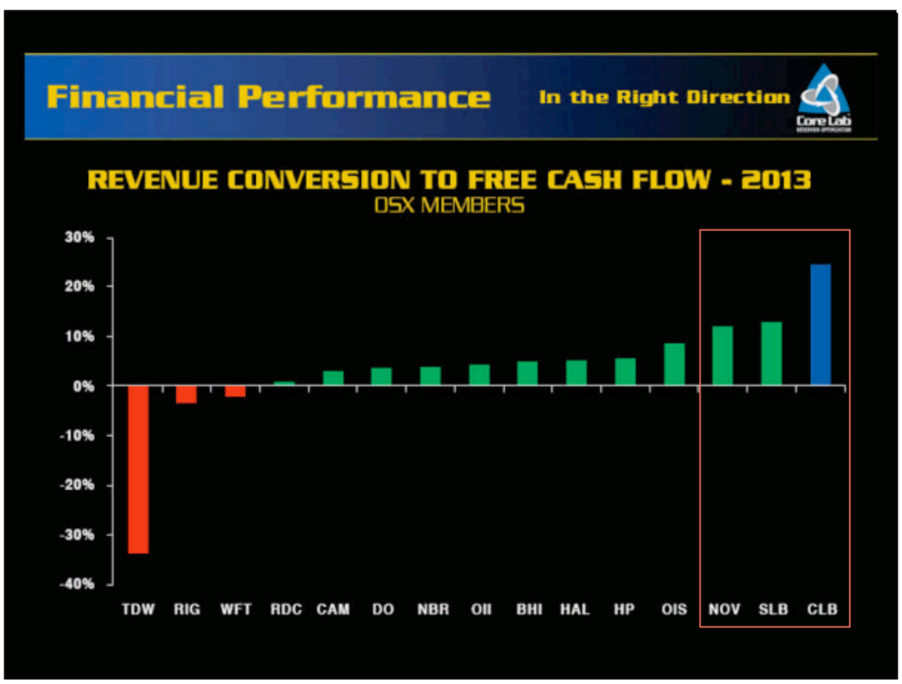
An example of a more meaningful overlap of profits within the portfolio would be Apple and Qualcomm. Like Apple and Google, Qualcomm is classified as competing in the “Information Technology” sector. However, Qualcomm is dedicated to developing and selling wireless communications technology, with products that include silicon-based modems for cellphones, particularly smartphones, and a licensing portfolio that includes essential technology for connecting wireless devices to cellular networks. So Qualcomm supplies many key products to consumer electronics manufacturers around the world, including Apple (and Apple’s manufacturing partners). We estimate around one quarter to potentially one third of Qualcomm's profits are derived from supplier payments from Apple. On the other hand, we think Qualcomm’s technology is a critical and necessary expense for Apple to make in order to provide a superior user experience. We think the key takeaway is that both Apple and Qualcomm derive very meaningful profits from each other. So we manage the Apple and Qualcomm profitability overlap by calculating an "effective" weight of their overlapping profitability pool, and then limit our effective weight of these two holdings to 15% of the portfolio.

Rounding out our IT holdings are Cognizant Technologies, EMC Corp and Visa - which could not be more different from each other in how they occupy the information technology sector. Cognizant is a provider of custom IT consulting and technology services as well as outsourcing services. EMC is a worldwide leader in information management solutions including data storage, protection, and analysis.

With their majority stake in VMWare, EMC's products are core building blocks driving the transition to cloud infrastructure. Finally, we have Visa, which operates the world's largest retail electronic payments network and manages the world's most recognized global financial services brand.

Another Economic Sector that was especially topical during the quarter is Energy, where we have long held oil service companies Schlumberger (SLB) and National Oilwell Varco (NOV). Both of these companies have demonstrable competitive advantages, evidenced by their peer leading profitability in integrated oil services and oil equipment, respectively. We also added a new holding to portfolios during the quarter, Core Laboratories, which holds a dominant profitability position in the oil service niche of applied data for petrophsyical characteristics.

According to a recent presentation from Core Labs, NOV, SLB and Core Labs (CLB) happened to be the three most profitable companies in the PHLX Oil Service Sector Index (OSX), on a free cash flow to revenue basis, during 2013. However, similar to our IT holdings, we believe it is coincidence that SLB, NOV and CLB are all considered to be in the same industry (much less index). More importantly, we own these businesses because we expect all three can sustain these superior profitability profiles because of their unique approaches towards creating and capturing value for shareholders. So while our energy service companies might have very similar customers (e.g. international oil companies, national oil companies, independent E&Ps), and be grouped accordingly by third-party information providers, we believe that a company's clients are only a piece of a business' overall profitability puzzle.




**Source: Core Labs Presentation Materials**

For example, Schlumberger employs over 120,000 workers in 85 countries, which is a highly valuable asset in and of itself, as the skilled employee base of the energy industry has been running into perpetual and significantly adverse demographic issues. The industry-wide shortage of workers makes Schlumberger's global network of learning centers that much more valuable to clients. Backing this army of workers is an annual research and development (R&D) budget of around $1.2 billion (trailing 12 months through the 3rd Quarter 2014), which we estimate is nearly two times larger than SLB's next largest publicly traded OSX peer. The technology and process innovation that results from this torrid R&D spend is deployed across its world-wide employee base and results in highly differentiated services, such as Schlumberger Production Management (SPM), which is where a client effectively outsources most of, if not all of, a mature field's production, on a fee-per-barrel basis, to Schlumberger's multidisciplinary team of field experts. Launched in 2011, SPM is responsible for the production of more than 140,000 barrels per day of oil equivalent.[3] Schlumberger's substantial investments in both experts and technology essentially allow the Company to become the "asset manager" of an Exploration and Development Company's well. So while Schlumberger's overall value proposition is to lower the cost of hydrocarbon production, they execute this value proposition with a vertically integrated services value chain, amplified by equipment and technology. Therefore, Schlumberger's profitability is heavily influenced not just by customer expenditures, but also by the sunk costs of oilfield employee training and technology-related R&D expenses.

A more recent addition to the portfolios, Core Laboratories, another Oil Service Company, and has been around for over 80 years, with trailing 12-month revenues just shy of $1.1 billion (through 9/30/2014). According to the Company, over 70% of these revenues are based on services, with the rest coming from sales of equipment and other products. The vast majority of Core's service revenues come from selling datasets related to laboratory results of reservoir rock core and fluid samples and provide Exploration and Production Companies with the most accurate descriptions of the actual petrophysical properties of their reservoirs. Over time, the Company has compiled an extensive library of direct reservoir data, spanning across most oilfields worldwide. Ultimately, Core's data are key inputs for a client to optimize well design and maximize production across the life of their constantly changing reservoirs. As for their physical products, Core focuses on highly differentiated, proprietary monitoring equipment, tracer technologies, and perforating systems - often times, Core's products have been developed using insights gleaned from their data services. With the collection and interpretation of vast quantities of petrophysical datasets, we see Core Labs as a leader in "Big Data" for the oilfield. As such, the majority of Core Labs' expenses consist of paying and training their roughly 5000 employees, particularly those focused on rendering

[3] http://www.slb.com/services/additional/spm.aspx

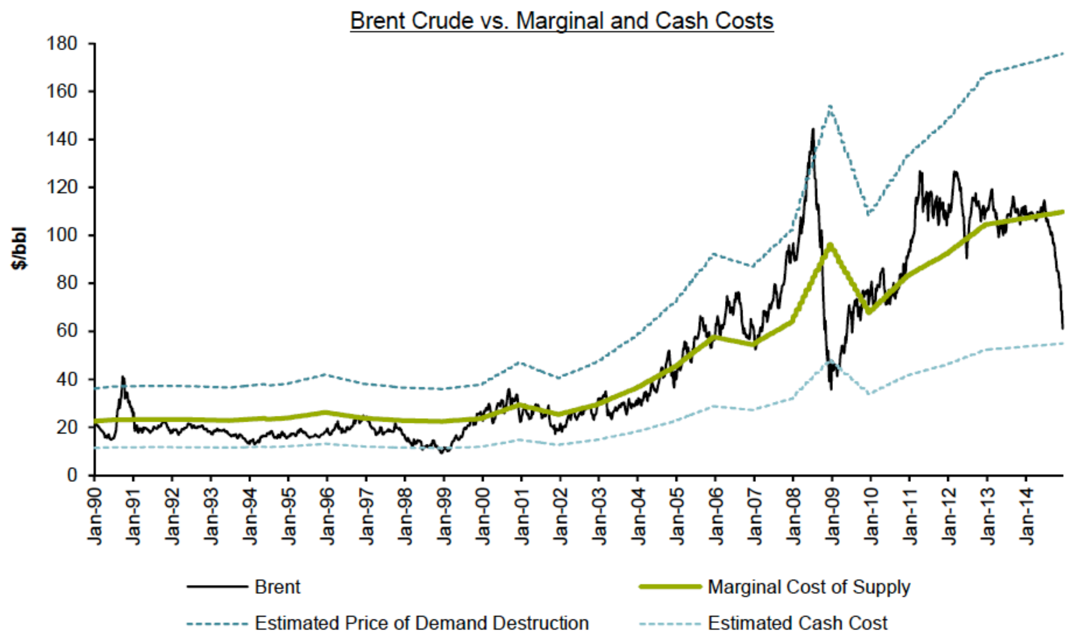
datasets in the laboratory. Interestingly, despite the Company's rapid growth over the past cycle, their employee count has remained relatively stable.

We also own National Oilwell Varco, which is the largest designer, manufacturer and support provider of major oil capital equipment in the world. We think NOV has been particularly successful due to their activities in the Rig Systems and Rig Aftermarket equipment segments. The Company has been consolidating the Rig Systems sub-industry for over 20 years, moving the industry away from a highly-fragmented, high-cost, low-efficiency, specialized jumble of businesses, towards a lower-cost, high-efficiency, standardized, one-stop-shop. A decade ago, it took roughly a dozen contractors to assemble a drilling package on an offshore rig. Today, that same process requires just a few, including NOV. As a result of NOV's differentiated strategy to vertically integrate rig equipment, we estimate NOV's rig market share is anywhere from 60% to 80%, which represents a dominant industry position and is a key reason for the Systems and Aftermarket segments' rich margins. Within NOV's Rig segments, the Company has 20,000 employees, including some 3,200 engineers and another 950 employees working in 23 shipyards, globally. Aside from the Rig segments, NOV also manufactures wellbore equipment (drill pipe, inspection, bottomhole assemblies, fluids/solids control) and completion equipment (floating production storage and offloading, coiled tubing, wireline, artificial lift). While they have more competition within the latter equipment segments, we think NOV's strategy of vertical integration through consolidation is just as relevant, though nascent, compared to Rig systems. In any case, we think NOV's posses a differentiated value chain, tailored to design, manufacture and service heavy-duty equipment, particularly for use in the oilfield, which we think are qualities just as - if not more - consistent with an industrial manufacturer, as much as with an Energy Company.

All three of our invested Energy companies derive substantial portions of their *revenues* from E&P budgets. While the dramatic decline in oil prices since the summer of 2014 are forcing the customers of our oil service companies to rein in their spending for 2015, we believe this will lead to significant pent-up demand over the next several years. Like most macro series that are driven by commoditized inputs, we believe oil will mean-revert, particularly to its marginal cost of production, which is meaningfully higher than prices at quarter end. There are numerous scenarios that could to this mean reversion, suffice it to say, we think the exceptional financial strength and value-added services should sustain and reinforce the competitive positioning and corresponding profitability profiles of NOV, Schlumberger and Core. Further, we believe that there is much more diversification across the *profitability* pools of NOV, SLB and CLB, than meets the eye. For example, while substantially all of Core Labs' revenues are derived from E&P budgets, more than two-thirds of Core Labs' profitability is derived from laboratory-based activities. While Schlumberger's revenues are also tied to E&P budgets, the activities of vertically integrating highly trained employees across oilfield disciplines and supplying them with cutting-edge processes and equipment is responsible for most of the Company's profitability. Yet NOV's activities are still different from SLB's and CLB's, as NOV focuses on activities as a vertically integrated industrial manufacturer of oilfield equipment and supplies. So while all three companies have substantially similar sources of revenue, they all have substantially different value chains and expense lines, which we think leads to effective profitability diversification.

Exhibit 9

**We expect oil prices to trend back towards the marginal cost (circa $100/bbl) as the supply / demand balance tightens**




Source: Bloomberg, FactSet, Company reports, Bernstein estimates and analysis

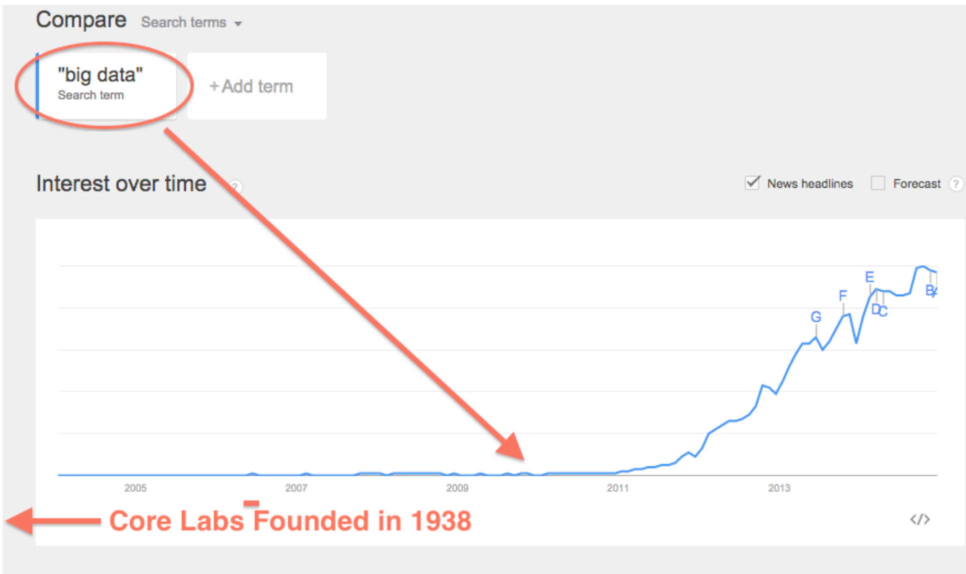
In summary, we believe that profits drive long-term equity performance. In order to offer a prudent level of diversification in a focused portfolio, we qualitatively analyze the overlap between the profitability drivers of our businesses. While large capitalized businesses often effectively compete across wide swaths of industry, we believe we can manage this overlap at the portfolio level, by limiting our investment in any profitability drivers to the tune of no more than 15%.

## Company Commentaries

## Core Laboratories

Core Laboratories has carved out a dominant and exceptionally profitable niche in the oil service industry. The Company has a singular focus on obtaining, analyzing and rendering proprietary datasets related to the quality, efficiency and efficacy of a client's oilfield production and development activities. In addition, the Company utilizes these data sets (and experience) to develop highly differentiated tools and equipment that are particularly useful during the development and production stages of an oilfield.

In essence, Core Labs is "Big Data," but considering that Core Labs was founded in in the 1930's, they were into "Big Data" well before the term started showing meaningful interest on Google Trends.




**Source: Google Trends Search *"Big Data"***

However, unlike some publicly traded "Big Data" companies - particularly those companies classified as "Information Technology" - Core Labs is extraordinarily profitable. Using return on invested capital (ROIC) as a proxy for profitability, the Company is at the top of the oil service industry – by a factor of 2X and 3X.

| Company | Return on Invested Capital (ROIC) | Weighted Average Cost of Capital (WACC) | Returns above WACC |
|---|---|---|---|
| Core Laboratories | 56.0 | 8.6 | 47.4 |
| National Oilwell Varco | 20.8 | 10.9 | 9.9 |
| Halliburton | 14.3 | 11.1 | 3.2 |
| Drill-Quip | 13.5 | 12.0 | 1.5 |
| Schlumberger | 12.5 | 10.6 | 1.9 |
| Carbo Ceramics | 11.0 | 9.3 | 1.7 |
| Group Average | 9.4 | 10.1 | –0.7 |
| Transocean | 6.3 | 9.1 | –2.8 |
| Nabors Industries | 5.1 | 9.4 | –4.4 |
| Baker Hughes | 3.3 | 9.5 | –6.1 |
| Weatherford International | 3.0 | 9.9 | –6.9 |
| Superior Energy Services | –5.2 | 11.9 | –17.0 |
| CGG | –8.8 | 8.7 | –17.5 |
| Key Energy Services | –10.1 | 10.7 | –20.8 |

**Source: Core Laboratories 2013 Annual Report**

We believe that Core Labs' peer-leading profitability stems from a laser-like focus on their petrophysical data analysis niche as well as strict capital discipline. Broadly speaking, the Company's goal is to reduce the risk and increase the reward of developing an oilfield – not too different from most oil service companies. However, Core's value chain is highly differentiated relative to most oil service competitors. In fact, much of Core's service work is developed in a laboratory setting (thus, the "Labs" in "Core Labs"), where they conduct controlled analyses of fluids and rocks obtained from a client's oilfield. These geological "core" and fluid samples represent direct measurements from an oilfield, so the resultant data sets that Core remits to the client represent the actual petrophysical properties of that client's hydrocarbon reservoir. The industry often refers to this data as "the ground truth." Compared to data sets from more indirect measurement services (e.g. wireline logs) favored by larger rivals, Core's unbiased and highly accurate applied data services serve as critical inputs for clients when designing the most optimal production processes.

We believe Core's long-term focus of developing and reinforcing their core and fluid dataset niche, and subsequent innovation in development and completion tools, is what has driven the Company to consistently superior rankings in customer satisfaction in the energy services industry, especially in core and fluid analysis. As for pricing these services, we estimate that the direct cost of most of Core's services represent a mid-to-low single digit percent of the total cost of developing a well, yet the value of the data greatly exceeds the cost of this service, as it is used in almost every phase of oil and gas development. Given the low cost/high-value nature of Core's services, combined with best-in-class capabilities and reputation, we suspect that the Company will have a strong grip on pricing power for many years to come. Furthermore, given the Company's competitive advantages and culture we view Core's profitability to be highly defensible, especially – particularly its culture of compensation – which revolves around ROIC. Simply put, anything that boosts relative ROIC, boosts executive and managerial compensation. Consider, there are only a few ways to boost ROIC: add value for clients and then increase prices/cut costs (increasing the numerator of ROIC) and/or become more capital efficient (reducing the denominator of ROIC) – both are very straightforward concepts that we think are notoriously absent from many corporate strategies. Yet the Company has mastered these concepts and motivated their employees accordingly. We think the scarcity of this highly disciplined approach is *prima facie* evidence that it is a difficult strategy to copy.

Core, too, has a long history of double-digit bottom line growth. The Company's total addressable market are exploration and productions (E&P) budgets - especially the production portion of the budgets, which the company believes has the lowest risk of being cut during downturns, due to the mission-critical nature of Core's value proposition. Core's services are critical because of the inherent, constantly changing profile of a hydrocarbon reservoir. For example, any time oil or gas comes out of a reservoir (it is in production), or fluids or gasses are added (production enhancement), the reservoir profile changes. These changes conspire to form the "decline curve" of a reservoir, which management suspects reduces global hydrocarbon production by 2.5% per annum – or over 2 million barrels of oil equivalent per day. So tracking those profile changes are key to maximizing returns on investment for E&P's, as the production decline curve of a reservoir "never sleeps." Effectively, Core's addressable market is any oilfield on the planet (the Company believes there are about 4,000 oilfields world wide), with the Company having done work on about 1,250 of those fields, increasing that count by a targeted 40 **to** 50 fields per year. Ultimately, we believe the Company can grow the top line by several percentage points faster than E&P budget growth, with high levels of productivity and stable pricing power driving even faster bottom-line growth.

Core Labs' superior profitability and capital discipline has led to exceptional financial strength, marked by over *50* consecutive quarters of free cash flow generation. The Company carries about $370 million in long-term debt, which we think is perfectly manageable, when compared to the roughly $250 million in trailing 12-month free cash flow. We do not expect Core to leverage the balance sheet for any sizeable M&A, given their obsessive focus on maximizing ROIC. However, we would welcome aggressive buybacks, given current historically attractive valuations.

After peaking at over 35 times forward earnings (a 10-year record) earlier in 2013, the stock has since pulled back to a range that is well below the stock's 5 and 10-year averages. It is in this range that we have felt comfortable adding the Company to portfolios. While we are certainly aware of the impending downturn in earnings over the next 12 months (driven by the precipitous decline in oil, inevitably flowing through to lower E&P budgets) we believe the market is overly discounting Core's longer-term potential for growth. The E&P industry is notoriously cyclical, but we believe the mission-critical nature of Core's businesses should insulate them in this cycle and for many more to come. We hope to continue purchasing shares at what appears to be historically attractive valuations.

January 2015

| | | |
|---|---|---|
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