



## Wedgewood Partners 4th Quarter 2015 Client Letter

### Back To Our Regularly Scheduled Stock Market

*"What The Fed did, and I was part of it, was front-loaded an enormous market rally in order to create a wealth effect...and an uncomfortable digestive period is likely now...The Fed is a giant weapon that has no ammunition left...It was The Fed, The Fed, The Fed... in my opinion they got lazy...and it is time to go back to fundamental analysis...and not just expect the tide to lift all boats...and as [The Fed] tide recedes we are going to see who is wearing a bathing suit and who is not"*

Former Dallas Fed President Richard Fisher, January 2016.

### Review and Outlook

2015 will go on the books as the worst relative year in our strategy's +23-year history – and our second worst versus the S&P 500 Index. Our investment process of applying strict valuation criteria to industry leading growth companies fared poorly still against our style benchmark in an environment that handsomely rewarded only a handful of the momentum growth darlings of the day. And out of favor we were! Out of the 24 stocks that we owned during 2015, only seven contributed positively to our relative performance. Furthermore, of those seven, only three stocks – Alphabet (formerly Google), Cognizant Technology Solutions and Verisk Analytics moved the attribution needle much. To state the obvious, very little went right for us this year.

Even during our best relative performance period (2009), never has such a large swath of the portfolio been so far out of sync with the market. Regardless of the timeframe, we continue to believe that the key characteristics of all our portfolio companies are superior relative profitability (as measured by Return on Assets and Return on Invested Capital) and the ability to drive earnings per share growth at a double-digit clip, over a cycle, while trading at out-of-favor levels, as dictated by our valuation work. In the face of these trials and tribulations, we promise to rigorously adhere to our time-tested investment process, with the assumption that if markets have a modicum of efficiency left in them, then we should soon realize quite a bit of pent-up relative outperformance, as the profitability, growth and valuation characteristics we insist on are significantly out of current favor.

<b>2015 Top Contributors</b>	<b>Avg. Wgt.</b>	<b>Contribution to Return</b>
Alphabet Inc Cl A	2.05%	0.79%
Cognizant Technology	6.09%	0.76%
Alphabet Inc Cl C	1.91%	0.73%
Visa	4.03%	0.69%
Verisk Analytics	3.75%	0.66%
<b>2015 Bottom Contributors</b>		
Qualcomm	7.57%	-2.64%
National-Oilwell Varco	3.70%	-2.21%
Berkshire Hathaway Cl B	7.69%	-0.90%
Schlumberger	4.85%	-0.83%
Cummins	2.19%	-0.79%

<b>Q4 Top Contributors</b>	<b>Avg. Wgt.</b>	<b>Contribution to Return</b>
Express Scripts	7.00%	0.53%
Coach	2.86%	0.51%
Alphabet Inc Cl C	2.18%	0.48%
Alphabet Inc Cl A	2.52%	0.48%
Visa	4.37%	0.46%
<b>Q4 Bottom Contributors</b>		
Qualcomm	7.26%	-0.42%
Apple	8.11%	-0.41%
Stericycle	3.47%	-0.39%
National-Oilwell Varco	2.89%	-0.33%
Perrigo	3.04%	-0.29%

For the year, our Composite (net of fees)<sup>1</sup> declined -6.5% versus the S&P 500 Index's return of +1.4% and versus the Russell 1000 Growth Index's return of +5.7%. The fourth quarter of 2015 was a particularly difficult quarter on a relative performance basis. Our composite gained just +1.9% versus the +7.0% and +7.3% gains in the S&P 500 Index and Russell 1000 Growth Index, respectively.

On a prospectively positive note, our portfolio is cheap and we believe of higher quality on a much higher comparative Return on Assets basis and a slight premium in forward earnings growth expectations and even stronger versus the less "growthy" S&P 500 Index. Specifically, our Composite portfolio is valued at a 12-month forward P/E of 16.8X - an 8% and 10% discount, respectively to the Russell 1000 Growth Index (18.3X) and the S&P 500 Index (18.6X). On a forward 5-year prospective earnings growth basis our portfolio clocks in at 14.1% - a 9% and 40% premium to respective indexes (Russell 1000 Growth Index: 12.9% and S&P 500 Index 9.83%)<sup>2</sup>.

<sup>1</sup> Portfolio contribution calculate gross of fees. The holdings identified do not represent all of the securities purchased, sold, or recommended, and past performance does not guarantee future results

<sup>2</sup> Per FTSE Russell and Morningstar

For the fourth quarter 2015, our best relative contributors during the fourth quarter were Express Scripts, Coach, both share classes of Alphabet (formerly Google), and Visa. Our worst relative contributors for the fourth quarter were Qualcomm, Apple, Stericycle, National Oilwell Varco, and Perrigo. For the full year 2015, our best relative contributors were both share classes of Alphabet, Cognizant Technology, Visa and Verisk Analytics. Our worst relative contributors were Qualcomm, National Oilwell Varco, Berkshire Hathaway, Schlumberger and Cummins.

We were quite active in the quarter with a total of nine portfolio changes. We sold our positions in Varian Medical, Cummins, National Oilwell Varco, and Coach. We increased weightings in Stericycle, Apple, Kraft-Heinz, LKQ Corp, and Perrigo.

Of note regarding our continued conviction to hold onto Qualcomm, we think Qualcomm's underperformance during the quarter was largely attributed to customer compliance issues and increasing regulatory scrutiny. Both pertain to Qualcomm's lucrative licensing segment, which accounts for the majority of the Company's profitability. Qualcomm continues to represent an excellent risk-reward trade-off, with shares trading at historically low multiples. Ample growth catalysts include management's aggressive investment in increasing customer compliance with respect to signing licensing agreements, as well as retaking market share in its still-dominant chipset business.

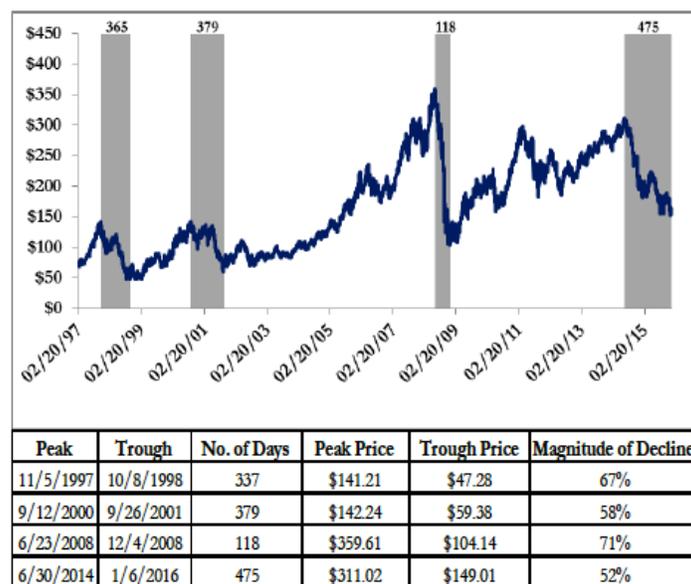
We think the existential crisis that the market is pricing into Qualcomm's shares is much too dire. First, China's "techno-nationalism" has made it notoriously difficult for U.S. technology companies to compete on the Mainland<sup>3</sup>. We believe too that Qualcomm's 2015 settlement with Chinese regulators over licensing practices represents a very unique and attractive new source of high-margin, revenue growth. To date, it has been difficult for Qualcomm to begin collecting, per their settlement. However, during the quarter, the Company announced that they had signed licensing agreements with four of the five largest Chinese mobile device original equipment manufacturers, so we expect to see licensing revenue ramp faster than the market is expecting. Second, we think there is a good probability Qualcomm wins back share at some key chipset accounts, which should bode well for margins, especially as the Company has invested in a nimbler cost-structure. Last, while we can attribute some of Qualcomm's recent stumbles to a mobile handset industry that is entering a more mature phase of growth, the Company is relatively further along in the process of converting its business model to reflect those realities, and we expect double-digit earnings per share gains over the next few years. We estimate that Qualcomm currently trades at a mid-single digit forward earning per share multiple, adjusted for net cash, which is a substantial discount to both the Russell 1000 Growth Index and S&P 500 Index. We expect continued significant buyback activity over the next several quarters, which should enhance the Company's per-share growth prospects.

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<sup>3</sup> For example, Google, Netflix, Facebook and Visa – to name a few – are all pre-eminent tech companies that have little to no presence in onshore China – ostensibly for different reasons

Our energy holdings were the “best of times and the worst of times” in 2015. As we nearly concluded building our weighting in three companies last January, Core Labs and Schlumberger rallied sharply into late April, +50% and +25% respectively from each of their January lows. We thought we accidentally timed a sharp V-bottom in the sector, even though that was not our intention as we assumed a 3-5 year time horizon in these positions. Then oil rolled over sharply and in the summer Russell slashed energy weightings in the benchmark to essentially zero. As the year ended we trimmed our total energy weight, as you will read about in more detail below.

**Exhibit 8. OSX Cyclical Downturns – Present vs. Past**



Source : Factset, Oppenheimer & Co. Inc.

During the quarter, we exited our investments in National Oilwell Varco (Varco). Varco continues to dominate the market for supplying offshore rigs with comprehensive drilling packages and equipment. However, over the past few years we have seen dual industry headwinds hit Varco's customers particularly hard in the form of prohibitively high offshore development costs, combined with a continuous flood of OPEC's low-cost oil supply. We concluded that the Company's customers - offshore drilling contractors, national oil companies and international oil companies - were systematically shifting their budgets away from offshore, towards onshore development, increasing the risk of another three to maybe even five years of low or negative earnings growth. In addition, while the company continues to have dominant market share, particularly in providing new and aftermarket equipment to offshore drilling rigs, we think this addressable market has the potential to contract for several years as cheap oil from OPEC countries crowds out higher-cost sources of marginal production, especially for non-OPEC offshore producers.

Varco's stock is no doubt cheap, at least based on the previous cycle's earnings power, but we think the secular shift away from offshore exploration and development

continues for a few more years, which makes the previous cycle difficult to use as a comparable. Further, Varco's exceptional financial strength affords them ample leverage to buy distressed assets, but in our view there are not many opportunities for them to grow their lucrative rig-tech businesses, where they have dominant market share. While Varco's long-term competitive strategy is heavily contingent on M&A, we have yet to see a material slow down in the availability of cheap capital to the sector, which has conspired to keep target asking prices above where Varco is willing to bid. In the meantime, management has signaled a less aggressive stance on share buybacks, despite what we think is a particularly attractive historical valuation, as they bide their time and husband capital for M&A. If the Company manages to close in on an attractive target to offset the long-term risk of offshore rig technology business, we will likely revisit Varco as an investment idea. However, we are skeptical that attractive returns are available, given the abundance of competing capital and the Company's already dominant position in rig technology.

Core Labs and Schlumberger continue to execute and operate like the savvy veterans they are in the continuing industry down cycle (crash). Valuations though have rarely been as cheap. Both Company's execution of the time-tested "best companies get better" playbook continues apace. This powerful playbook includes successfully resizing their respective businesses in order to generate better "decremental" margins, meaning how much profits fall for a given fall in revenues. For example, during Schlumberger's last quarter they reported that although revenue fell -6% sequentially to \$8.5 billion from their second quarter, their margins only fell by 101 basis points. Better decremental margins contribute directly to healthier than expected cash flow. Indeed, the Company reported pre-tax cash flow from operations of \$2.5 billion and free cash flow of \$1.7 billion. In addition, free cash flow was a sterling 170% of earnings<sup>4</sup>. Such operating excellence is a huge competitive advantage particularly in the teeth of an industry crash when opportunities for both accretive stock buybacks and acquisitions avail themselves.

Core Labs current operating results continue to be best of breed. If one didn't know that the Company is an oil service company their recent operating results wouldn't offer any clues. For the third quarter, the Company reported a -3% sequential decline in revenues to \$197 million. Cost of services held steady at 62.7%, while cost of products actually decreased 300 basis points to 74%! Over the past three quarters the Company has converted 25% of their revenues into \$151 million of free cash flow - an improvement from 22% converted in the same period last year and represents over 150% of net income<sup>5</sup>. The current -70% crash in the price of crude is on par with the worst such crashes over the past 50 years, yet over the trailing twelve months the Company's return on invested capital is 40%. Astonishing!

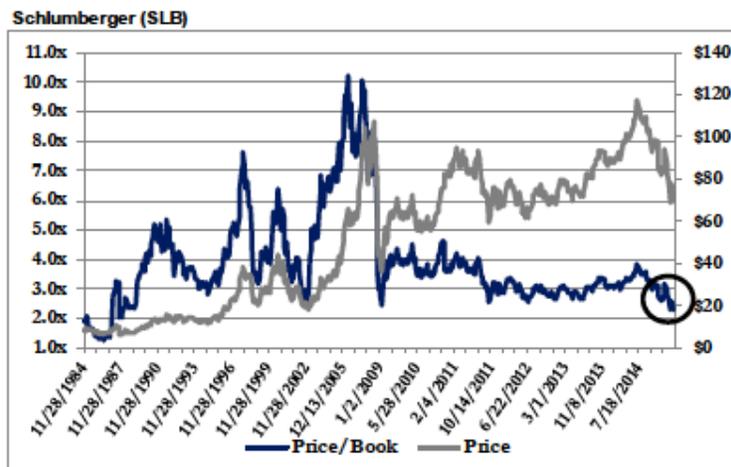
Both companies continue to be prodigious buyers of their own stock too. In August, Schlumberger announced a transformative \$15 billion acquisition of Cameron -

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<sup>4</sup> Schlumberger SEC filings, 3<sup>rd</sup> Quarter 2015

<sup>5</sup> Core Labs SEC filings, 3<sup>rd</sup> Quarter 2015

ushering in a new era of global “pore-to-pipeline” products and services. New and complementary technologies and services will be achieved through integration of the Company’s reservoir and well technologies, along with Cameron’s leadership in surface, drilling, processing and flow control technologies. Schlumberger has recognized that the E&P industry simply must transform itself at a time of prospective lower-for-longer, range-bound commodity prices. The combined Company’s deep reservoir knowledge, further enabled by instrumentation, software and automation, will launch a new era of competitively advantaged complete drilling and production system performance. In our view, Schlumberger is in a class by itself.



Source: Factset, Oppenheimer & Co., Inc.

We sold Varian Medical Systems early in the quarter. The Company maintains its position as the dominant supplier of radiotherapy equipment and software, worldwide. We see Varian’s core business growing earnings per share at a steady, low to mid-single digit rate, as developed markets have reached maturity. In addition, the dramatic devaluation of the Japanese yen relative to the U.S. Dollar has caused some competitive pressures in its non-core Imaging and Components segment, further pressuring growth. While Imaging Components might regain competitiveness over the next few years, we do not think it will be enough to drive earnings growth to our required rate.

We also sold Cummins during the quarter. We typically tolerated Cummins’ more cyclical end-market exposure due to their superior competitive positioning and continuous share-take. Much of this has been attributed to the Company’s technological leadership, which drove some key competitors out of the market since 2008. However, as the NAFTA truck cycle slows, management guided decremental margins to levels that we were disappointed with, given their superior competitive positioning. The Company has executed well, at least in its critical Components, and Engines businesses, but we worry it is the recent re-entry of competitors that might be causing their profitability to moderate at a difficult point in their product cycle.

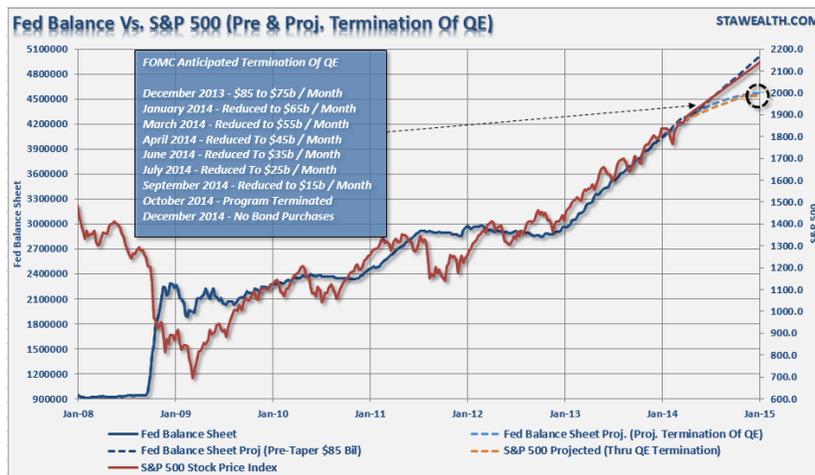
We also exited our positions in Coach as we have seen the Company's international unit, particularly in China, dramatically slow (on a constant currency basis). Relatively speaking, their results in China are still exceptional. Coach competes well below the price points of higher-end luxury players, and therefore has avoided the negative side effects of the Chinese Government's corruption crackdown that has curtailed a wide swath of demand for higher-end luxury goods. However, on an absolute basis, we find it marginally more difficult to make the case for Coach's long-term, double-digit earnings per share growth rate.

We added to positions in Stericycle after the stock sold off on what we view was an over-reaction to weakness in the Company's non-core, industrial waste business. Albeit a surprise, we think this weakness is limited to a mid-single digit percent of the Company's revenue. In our view, the rest of Stericycle's business, including the recently acquired Shred-It, is a very high-quality, steady growth model.

Perrigo is another position that we added to during the quarter. We had previously pared positions at materially higher levels after Mylan's hostile bid for Perrigo became public information. Upon the recent expiration of the hostile offer, shares traded down to valuation levels not seen since 2008-2009, at which time we added back to our position. Management has guided to solid future growth, driven by the Company's leading position in manufacturing and distributing private label over-the-counter (OTC) drugs to U.S. retailers, as well as its relatively new and rapidly expanding European OTC platform.

### Back To Our Regularly Scheduled Stock Market

In far too many of our past Letters we have felt compelled to comment and prognosticate on the extraordinarily accommodative monetary policy from our Federal Reserve, but also on central banks around the world too. The quote from Fischer at the top of this Letter is an admission (guilty plea?) of the highest order. The 2009-2015 bull market was historic. It was only the third bull market that the S&P 500 Index tripled in just six short years since 1900 – the other two end in 1929 and 2000 (the NASDAQ roared to a 310% gain). The Fed's role in this great bull market was historic as well. But notice what has been occurring since early 2014, the rate in which the Fed's balance sheet (Quantitative Easing) has been *decelerating*. To torture a metaphor or two, the Fed didn't suddenly take the QE-punch bowl away at the stroke of midnight. Rather, they have been spiking the go-go bull market juice with less and less intoxicants.



So, lets fast forward to the end of 2015. According to the Federal Reserve's *Quarterly Report on Federal Reserve Balance Sheet Developments* dated November 2015, the Fed's balance sheet assets grew to \$4.49 trillion through October 2015, a piddling increase of just \$3 billion from October 2014. Of note, the expansion of the balance sheet from October 2013 thru October 2014 was \$643 billion. Said another way, the Fed's punch bowl over the past year or so is just 2.5% beer – certainly less filling, and doesn't taste great to the uber-bulls. Is it any wonder that many measures and the stock market began to peak by the summer of 2013?

#### Timeline Of The Top

May 10, 2013	- NYSE Weekly 52-Week Highs
May 15, 2013	- NYSE Daily 52-Week Highs
June 23, 2014	- Junk Bonds (BofA/ML High Yield)
July 3, 2014	- EAFE (USD)
September 3, 2014	- MSCI Emerging Markets (USD) - S&P/Toronto SE Composite
December 29, 2014	- Dow Jones Transports - S&P 1500 Daily A/D Line
January 29, 2015	- Dow Jones Utilities
March 2, 2015	- S&P 500 Cyclical Sector Index (Equal-weighted composite of Consumer Discretionary, Industrials & Materials)
April 10, 2015	- DAX
April 15, 2015	- Value Line Arithmetic Composite
April 24, 2015	- NYSE All Issues Daily A/D Line - NYSE Weekly A/D Line
April 27, 2015	- FTSE 100
May 18, 2015	- NYSE Stocks-Only Daily A/D Line
May 19, 2015	- Dow Jones Industrials
May 21, 2015	- S&P 500 - NYSE Composite
June 12, 2015	- Shanghai Composite
June 23, 2015	- Russell 2000 - S&P MidCap 400 - NYSE Financials
June 24, 2015	- Nikkei 225
July 20, 2015	- NASDAQ Composite - S&P 100 (OEX)
November 3, 2015	- NASDAQ 100

Source: Leuthold

Relatedly, in our Letter from last January entitled “2015: Ground Hog Day or Wizard of Oz” we wrote:

***“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.”***

So, here we are. Last month, on December 16, the Federal Reserve officially changed their monetary policy by raising its target interest rate all of .25% from zero. It was

the first interest rate hike by the Fed since June of 2006. This increase was the most telegraphed move since Denny McLain of the Detroit Tigers served up a fat pitch to Mickey Mantle on the eve of his retirement. Mantle requested *“high and tight, mediocre cheese”* and McLain delivered.



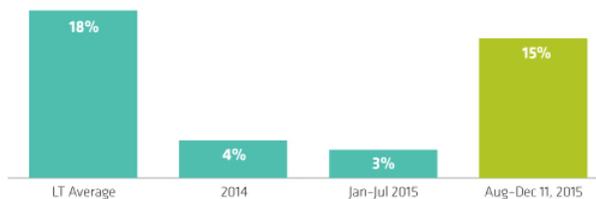
Mickey Mantle rounding the bases after on Sept. 18, 1968 hitting his 535th career home run. Denny McLain and catcher Jim Price let Mantle know what pitch was coming. Bettmann/Corbis

By August last year, Fed Chairman Janet Yellen telegraphed that future rate changes were going to be *“high and tight.”* Fed rate hikes, after a spell, typically are not *“mediocre cheese.”* Mr. Market has certainly taken notice since. Daily stock market volatility since last Fall – and continuing in earnest to start off 2016 – is anything but mediocre cheese.

**DAILY VOLATILITY SHOT UP AFTER A SUBSTANTIAL LULL**

PERCENTAGE OF DAYS WITH INTRADAY TRADING RANGE GREATER THAN 2%\*

S&P 500 Index



As of December 11, 2015

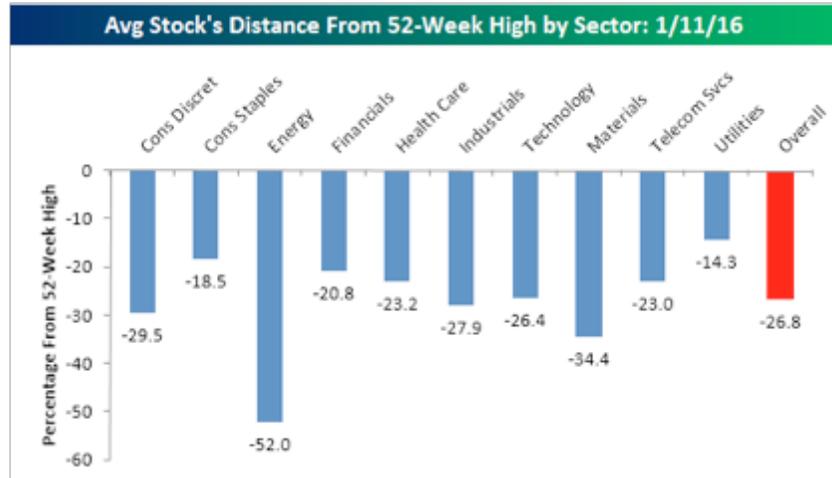
\*S&P 500 Index's intraday range is calculated as the difference between the highest price and the lowest price of the day, divided by the closing price.

Long-term average since January 2000

Historical analysis is not necessarily indicative of future results. There is no guarantee that any estimates or forecasts will be realized.

Source: S&P and AB

Readers of our more recent Letter's may recall our concerns on the stock market's valuation<sup>9</sup>. Indeed, one of the most striking attributes of the Great Bull Market has been the huge increase in the valuation in many stocks. Risk seekers had little to fret about regarding outsized valuations as long as the Fed had their back. These days are long gone. In fact, many stocks in most sectors have been in their own bear markets for some time now.



Source: Bespoke

In addition, now that the Fed's "buy-the-dip" trapeze net is no longer part of the investment scene, perhaps the outsized valuations of momentum oriented growth stocks (FANG<sup>10</sup>) will come back down to earth, to the relative benefit of more value oriented investment strategies (such as ours).

<sup>9</sup> 4<sup>th</sup> Quarter 2014 Commentary, pages 9 and 10; 2<sup>nd</sup> Quarter 2015 Commentary, pages 6 and 7; 3<sup>rd</sup> Quarter 2015 Commentary, pages 5 and 6

<sup>10</sup> Facebook, Amazon, Netflix, Google (now Alphabet)



Momentum = top 3 deciles, 12-mo. minus 2-mo. pct. price change.  
 Value = bottom 3 deciles, price-to-book.  
 Portfolios rebalanced monthly.

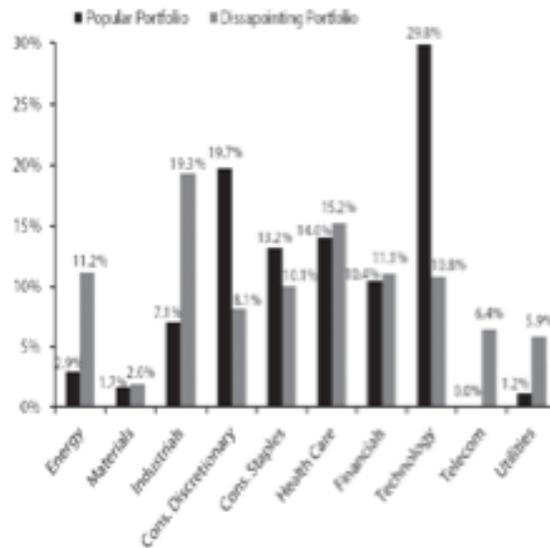
**Value & Momentum  
 During The Last 12 Months Of  
 Post-WWII Bull Markets**

Date of Cyclical S&P 500 High	Value 12-Month Total Ret.	Momentum 12-Month Total Ret.
August 2, 1956	11.3 %	26.0 %
December 12, 1961	33.1	34.6
February 9, 1966	24.4	37.0
November 29, 1968	36.4	18.7
January 11, 1973	17.7	27.5
September 21, 1976	51.3	28.4
November 28, 1980	18.7	73.7
August 25, 1987	25.6	34.3
July 16, 1990	3.4	18.5
July 17, 1998	30.9	34.5
March 24, 2000	-3.8	49.9
October 9, 2007	17.9	24.8
April 29, 2011	4.0	18.4
May 21, 2015	8.3	18.2
<b>Average:</b>	<b>19.9 %</b>	<b>31.7 %</b>
<b>Median:</b>	<b>18.3 %</b>	<b>27.9 %</b>
<b># Times Best Return</b>	<b>2</b>	<b>12</b>

Value = Large Cap, High Book-to-Market portfolio.  
 Momentum = Large Cap, High Momentum portfolio.  
 Based on total returns from Ken French Data Library.

Lastly, consider the prospect that the big winners in 2015 may have won too big to sustain their leadership. James Paulsen of Wells Capital Management compared the valuation spread of a "Popularity Portfolio" versus the valuation of a "Disappointing Portfolio." The sector compositions of each portfolio are displayed below.

Current portfolio sector composition — Popular Portfolio vs. Disappointing Portfolio

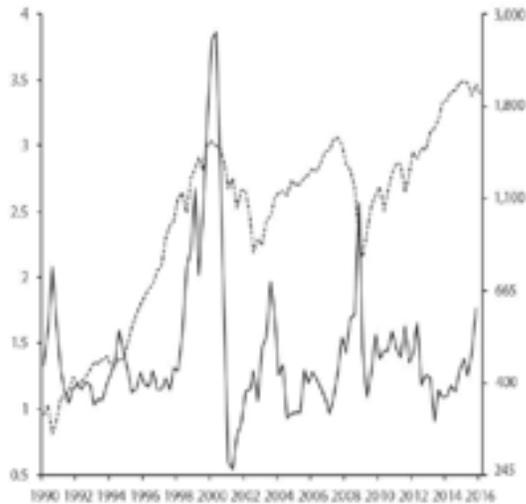


Paulsen concluded:

*“The most recent spike in the valuation spread, however, is similar only to what occurred in the late 1990s. Like then, the valuations of the two portfolios have moved in opposite directions during the last year. P/E multiples on popular stocks have increased while P/E multiples have declined among disappointing stocks. In the last 25 years, only during the dot-com bull market of the late 1990s did the valuation ratio behave as it has in the last year...rarely have popular stocks been so expensive when disappointing stocks have been so cheap... currently, the median P/E multiple on the Popular portfolio is in the 85th percentile of its historic range at about 23 times forward earnings estimates. Only during the dot-com era were popular stocks more expensive than they are today. Conversely, the Disappointing portfolio currently sells at only 13 times forward earnings, a P/E multiple which is lower than 70% of the time during the last 25 years...consequently, investors currently have a rare opportunity (at least during the last 25 years) to sell popularity when it is both relatively and absolutely expensive and buy disappointment when it is both relatively and absolutely cheap.*”

**Valuation Ratio — Popularity to Disappointment\***

\*Solid (left scale) — Valuation ratio: Median P/E multiple of top quintile S&P 500 previous year performers divided by the median P/E multiple of the bottom quintile previous year performers.  
Dotted (right scale) — S&P 500 stock price index, natural log scale.



Suffice it to say that 2015 was no doubt a disappointing year for us and our clients. As we stated earlier in this Letter, we believe that the current portfolio is constructed of best of breed businesses with superior relative fundamentals, and is quite cheap to boot. We look forward to delivering better performance in 2016 and beyond.

We hope these Letters give you some added insight into our portfolio strategy and process. On behalf of Wedgewood Partners, we thank you for your confidence and continued interest. As always, please do not hesitate to contact us if you have any questions or comments about anything we have written in our Letters.

David A. Rolfe, CFA

Michael X. Quigley, CFA

Morgan L. Koenig, CFA

Chief Investment Officer

Senior Portfolio Manager

Portfolio Manager

Senior Research Analyst

Research Analyst

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**The information provided in this material should not be considered a recommendation to buy, sell or hold any particular security.**

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<sup>i</sup> Returns are presented net of fees and include the reinvestment of all income. “Net (Actual)” returns are calculated using actual management fees and are reduced by all fees and transaction costs incurred.