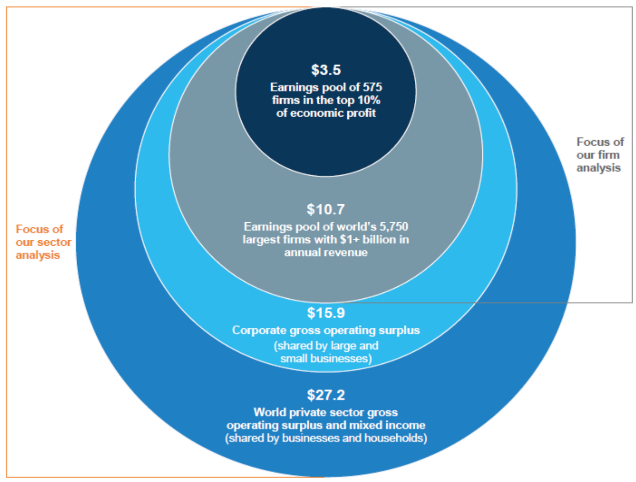
Winner Takes All

The Top 10% of Firms Capture 80% of the Economic Profits

World gross operating surplus and share accruing to corporations as EBITDA[1]
$ trillion, 2014–16 (3-year average)



1 Gross operating surplus is an economic measure that represents the income earned by capital. It is calculated as gross value added less compensation of employees and taxes on production and imports. EBITDA (earnings before interest, tax, depreciation, and amortization expenses) plus research and development expense (R&D), is the closest corporate financial proxy for the economic measure of gross operating surplus. See Peter Chen, Loukas Karabarbounis, and Brent Neiman, "The global rise of corporate saving," working paper number 736, Federal Reserve Bank of Minneapolis, March 2017. Corporate earnings pools are estimated based on EBITDA margin and R&D expenses relative to total revenue pools in each category. EBITDA margins of 12.6%, 14.3%, and 18.1%, and R&D-to-sales ratios of 3.0%, 4.9%, and 7.0% used for firms in McKinsey's corporate finance data set, firms with over $1 billion in annual revenue, and firms in top 10% of economic profit, respectively.

SOURCE: IHS; OECD; McKinsey Corporate Performance Analytics; McKinsey Global Institute analysis

Source: McKinsey

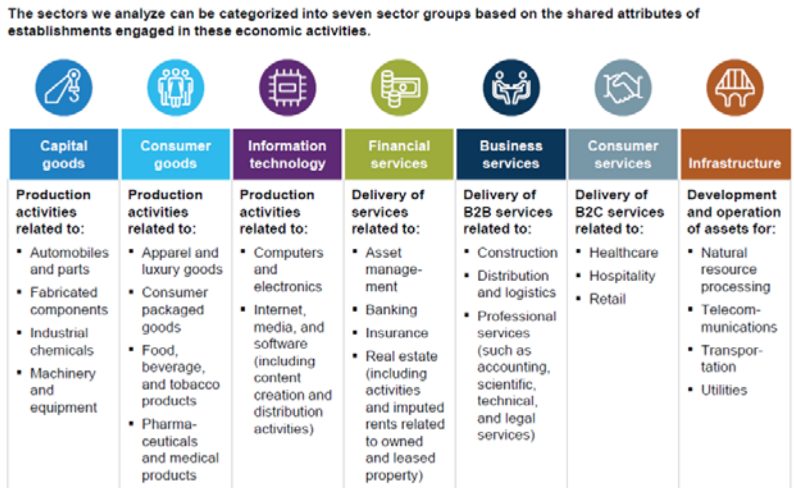
One of the purposes of our monthly reports is to provide our clients with a perspective on how we manage their investments. Frequently, we have manager research teams that perform due diligence on our operations to analyze and assess how we manage their clients' assets for their institutions. This past month, we hosted a research team from Philadelphia and we introduced our process to them in our offices in Virginia Beach. While much of our presentation is standardized and quantitative, it is the qualitative aspects of describing our investment approach that provokes the most interest during our discussions. How are stocks selected versus those that are discarded?

One of our primary investment tenets is investing in companies with exceptional returns on capital. By owning a select portfolio of companies versus a random collection of stocks based on market capitalization, we believe we can create portfolios that generate excess returns above the index. This month, the consulting firm McKinsey published a research report on "superstars" in the global economy. What makes a "superstar?" While one may think that the global economy is competitive, in terms of generating economic profits, it is, "a story of the haves and have nots." Per McKinsey, of the 6,000 companies with $1 billion or more in revenue, the top 10% capture 80% of the economic profits, the middle 80% essentially zero, and the bottom 10% destroy value. Moreover, the top 1% capture 36% of economic profit.

These companies have returns on capital 5x that of the bottom 10% and can continue to stay in their top position as their research and development intensity is higher, enabling them to extend their lead versus the pack.

What makes the study more interesting beside the fact that its author was the Equity Opportunity Group's founder, George Shipp's business school roommate, is that looking for market leaders has been a key qualitative focus of our team's research process since inception. In fact, in keeping with the McKinsey study, the introduction of product commentaries for decades have included as part of their philosophy searching for market leaders when selecting stocks. Specially we state we seek companies where their "size usually translates to cost advantages in production, marketing, and R&D expenditures that can be re-invested back into the business, making such advantages sustainable."

Do our strategies align themselves with the observations of the McKinsey study in an effort to own



Source: "International standard industrial classification of al economic activities, revision 4," United Nations Department of Economic and Social Affairs, Statistics Division, 2008; McKinsey Global Institute analytics

stocks that are trying to capture the 80% of economic profits in the marketplace? McKinsey notes that companies in certain sectors tend to share attributes to capture inordinate economic value and can be seen in the graphic above.

Generally, Equity Opportunity Group portfolios have strong representation to these fertile areas of economic value creation and have over time. We'd note exposure in current strategies to automobiles and parts, consumer packaged goods, pharmaceuticals, media and software, real estate, professional services, and healthcare.

McKinsey notes superstars benefit from the "Matthew Effect" summarized as: "To those who have, more shall be given." Given a choice, why not shoot to own companies whose business capture the greatest gains in revenue share, and often earn higher profit margins over time? We chose to target these companies in our efforts.

As always thank you for your interest and trust managing your investments.

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