HS MANAGEMENT PARTNERS, LLC

investment styles ebb and flow . . . fundamentals never go out of favor

Stay in Your Lane

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Year five of the Great Equity Market Revival from the Great Recession is nearly complete, and 2013 is poised to rank as the best year for the S&P 500® from the low (including the robust 2009 inflection rebound), with a notable 29%+ market advance registered through November. The fear of September 2008 has yielded to the greed of December 2013; equity market participants are nothing if not consistent, ignoring the sage axiom "all things in moderation."

It is at the fringes of fear and greed when emotions often supplant reason, that sensible investment principles can give way to the allure of new age thinking. Behavioral finance has well documented the irrationality of decision making at such extremes: an abundance of caution at market bottoms, complacency at market tops. The prescience of Warren Buffett is obvious: "We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful."

From HS Management Partners' (HSMP) perspective, these moments are precisely when the time tested tools of the trade require affirmation in the investment decision-making process. Our investment philosophy is straightforward: "investment styles ebb and flow…fundamentals never go out of favor." The fundamental precepts of identifying quality businesses, the fundamental valuation discipline we employ, and the fundamentals of applying our best thinking to the active management of our clients' scarce capital is pervasive in our approach.

To be sure, there are times when markets in the fast lane may pass us by for a stretch, though we also know the incidence of accidents is higher the faster you travel; similarly, we have to maintain a speed that keeps our clients well ahead of those in the slow track. We prefer the lane where our investment GPS is guided by fundamentals, for this is where we've found the journey to be safer, and where the road – while occasionally bumpy – is paved with a high level of understanding and conviction around our process.

Around the Bend…

Markets are anticipatory by nature, and the uncertainty associated with defining precise outcomes is tempered by the application of discount rates to arrive at a present value of inherently variable future cash flows. While intricate financial models attempt to account for contingencies known and unknown – i.e., the Black Swan – more qualitative and cautionary comments from well regarded observers have caught our attention of late.

BlackRock CEO Larry Fink commented in late October that Fed policy is contributing to "bubble-like markets," referring specifically to "a huge increase in the equity market" and that "we've seen corporate debt spreads narrow dramatically." Fink subsequently suggested that most pension plans with which he is familiar are underinvested in equities and that an equity market decline would present a buying opportunity.

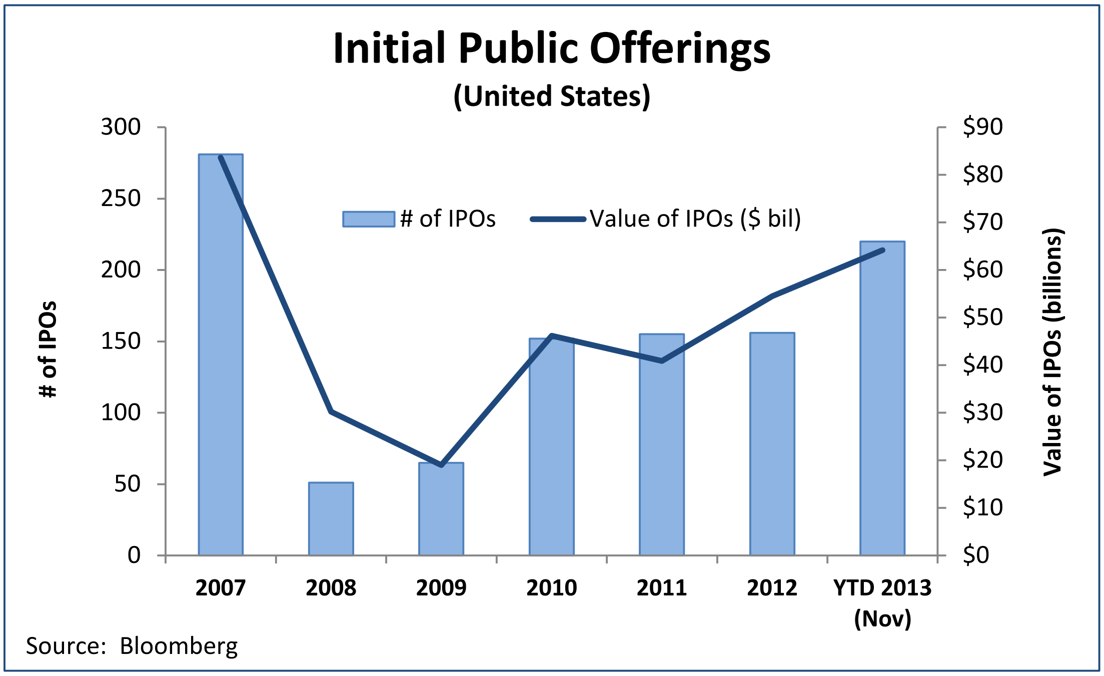
PIMCO's December Outlook, penned by Bill Gross, offered the notion of a "T junction" in which markets approach an inflection point, heading bubbly right or bubble-popping left due to the negative aspects of fiscal and monetary policies in a highly levered world. Gross suggested the T might take on the form of a winged eagle with a more gradually sloping left or right. Regardless, Gross suggested that "overlevered economies and their financial markets must at some point pay a price, experience a haircut, and flush confident investors from the comfort of this Great Moderation Part II."

A recent Bloomberg Global Poll suggested a majority of respondents believed asset bubbles are forming in Internet and social media stocks as well as in London and China housing markets, while former Fed Chairman Alan Greenspan recently referred to the Bitcoin phenomenon as a bubble.

…On and Off Ramps

Amidst this backdrop, it is worth considering the actions and, by inference, the motivations of business owners. In that regard, the contrast between the owners of private companies electing to sell a portion of their enterprise into the public realm via IPO's and secondaries stands in contrast to the behavior of many companies comprising HSMP client portfolios where active share repurchase programs exist.

The chart below illustrates that 2013 has been a very good year for the U.S. IPO market and, by extension, the owners of those businesses migrating from private to public hands. As shown, IPO activity through November has substantially exceeded the 2012 calendar year, and December is off to a strong start. The heightened level of activity is also noteworthy in that 2012 had one large deal – Facebook's $16 billion offering – representing over 30% of the dollar value of assets raised last year.



There is little question U.S. equity market participants will be celebrating this holiday season; the motivations of sellers are completely understandable. Those liquidating positions are sophisticated investors with deep knowledge of their businesses and a view of the value of their enterprises. According to Dealogic, approximately 41% of U.S. listed IPOs through October were backed by private equity firms. It is also reasonable to assume they are selling, in part, because a good portion of intrinsic value has been realized. Knowledgeable sellers would not be passing through the off ramp if their collective view was that significant appreciation still existed.

The performance of select IPO's is also a noteworthy trend within the trend. Dealogic's monitoring of IPO performance identified that six IPO's had doubled on the first day of trading this calendar year; in the preceding 12 years, there had been only eight cases where an IPO had doubled on its initial trading day.

Coincident with and counter to this trend, the HSMP portfolio of companies – managed by similarly sophisticated business professionals with deep domain knowledge and therefore a view of intrinsic value today and a perspective on the potential of tomorrow – have been repurchasing shares, finding the earnings yield and cash flow characteristics of their businesses compelling relative to alternate uses of cash.

Among the 25 equities comprising client portfolios in early December, 21 of the 25 had a lower share count at the end of their most recent reporting period than existed at the beginning of the year, with a 1.7% reduction in the portfolio weighted average share count. Approximately $47 billion had been allocated to buybacks on a gross basis ($41 billion net of options exercise), a sizable commitment and one indicative of the confidence management teams have in their business prospects.

As the capitalization shrinks, our clients effectively become larger owners of a defined income stream. Given that we anticipate future growth in earnings and cash flows among our holdings, our clients are positioned as a larger proportionate stakeholder of an increasing profit pool. We prefer our alignment with conviction based management teams, and believe our clients are best served with a seat on the retirement - rather than issuance - side of the equity allocation ramp.

HSMP's Lane and the Road Ahead

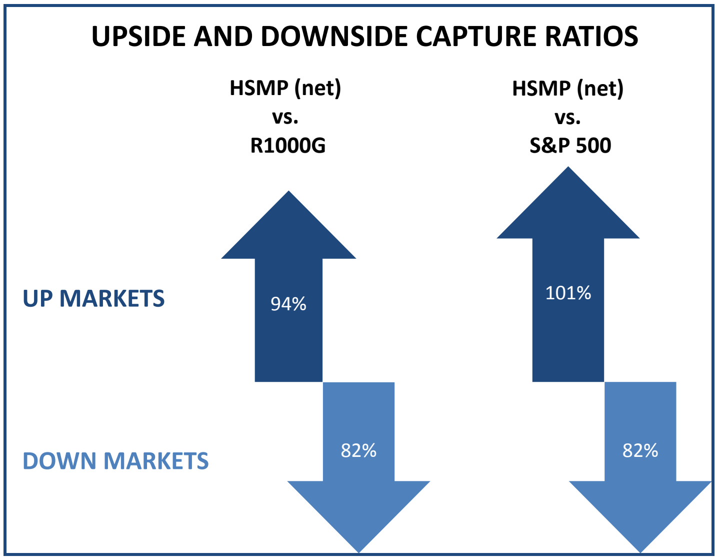
At HS Management Partners, we take great satisfaction and pride in serving as a solution to our clients' funding challenges. The entire team at HSMP is focused on the mission at hand. We offer one product, believe in the virtue of focusing all Firm capabilities on the successful execution of that offering, and think our clients are best served by dedicating all resources to doing one thing well rather than diluting our focus, thereby raising the likelihood of being average at many things.

In a low inflation (and many would postulate deflationary) world accompanied by synchronized central bank policy accommodation, individuals and institutions are faced with the challenge of how to prudently invest their capital. A climate of historically low interest rates, cyclically high equity markets, and alternatives which have broadly produced more outsized manager fees than client returns make for interesting deliberations among investment committee members and families alike.

As we approach the seven year anniversary of our performance track record (April 2014), we find it useful to reflect on the many market cycles we've experienced dating to the early 80's, when HSMP's principals started in the investment profession. Markets inevitably rise and fall, and a pullback following such a robust year for equity performance, capping a strong five year run, would not be at all surprising. Indeed, our style is such that we are mindful of actively managing client portfolios with a fundamental compass so as to take advantage of valuation anomalies that often occur at the fringes of fear and greed.

We do so by identifying transparent, easily understood business models operated by management teams capable of delivering above average earnings and cash flows in a highly visible manner; by managing our Concentrated Quality Growth portfolio in an active, highly incremental fashion so as to apply our very best thinking to the assets entrusted to us; and by adhering to a disciplined valuation framework.

One manifestation of our approach is captured in a widely viewed measure of participation in advancing as well as declining markets known as the upside/downside capture ratio. The data below captures the performance of the HSMP Concentrated Quality Growth Portfolio since inception and covers 80 discrete monthly intervals (April 2007-November 2013 inclusive). Over that span, the Russell 1000® Growth Index advanced 48 months while declining on 32 occasions, whereas the S&P 500® advanced 50 months while declining on 30 occasions. HSMP's Concentrated Quality Growth Portfolio has managed to participate in much of the upside during market advances while reasonably preserving capital in months when the market was under pressure.



Note: See disclosure below.

Our valuation discipline – relying on the forward twelve month P/E, free cash flow yield, and a calculation of appraised present value – has held us in good stead over time. While our resolve on valuation can lead us to sell positions that look extended based on our work, it is also the case that in sharply advancing markets (such as this year), when fundamentals (and common sense) are sometimes dismissed, such sales can prove premature. However, over market cycles, these tools have proven to be very effective, and we are quite comfortable with the ride as we travel in the HSMP lane.

As 2013 draws to a close, we take pride as we reflect in the rear view mirror, though our gaze is firmly through the windshield, for the 2014 road awaits.

On behalf of the entire HS Management Partners team, and to all we've had the pleasure and honor of working with over the years, best wishes for a happy, healthy, celebratory and peaceful 2013 holiday season.

Note: Analysis of monthly returns since inception (4/1/07) through 11/30/13. Upside [downside] ratios computed by dividing the cumulative annualized return of the HSMP Composite (net of fee) in months of positive [negative] index returns by the cumulative annualized return of said index for those same months. Please refer to the appendix for important disclosures relating to performance and trademarks. Past performance is not indicative of future results.

Annualized Performance as of 11/30/13				
	1 Year	3 Years	5 Years	Since Inception (4/1/07)
HSMP Composite (net)	28.2%	21.4%	22.3%	11.3%
Russell 1000® Growth Index	29.7%	17.4%	20.1%	8.0%
S&P 500® Index	30.3%	17.7%	17.6%	6.0%

HS Management Partners, LLC (HSMP) is an independent SEC registered investment adviser. HSMP claims compliance with the Global Investment Performance Standards (GIPS®). The Firm maintains a complete list and description of composites. The Composite includes all fully discretionary fee paying accounts which employ our style of investing in 20 to 25 quality growth businesses. These accounts must have a market value of greater than $500,000 at the time of initial inclusion, including those accounts no longer with the Firm. The U.S. Dollar is the currency used to express performance. For more information or for a copy of our fully compliant presentation, please contact us at 212.888.0060.

For benchmark purposes, the Composite is compared to the S&P 500® and Russell 1000® Growth indices, however, the Composite may contain securities not represented in either or both indices.

This piece represents the opinion of HSMP as of December 2013, based on our understanding of current market conditions and reported information about the aforementioned companies. The opinions stated herein are subject to change without notice and are provided solely for purposes of discussion. No services or securities are offered hereby. While we believe that our investment strategy will produce desired returns, we do not intend and cannot guarantee this will occur. Investment in securities can involve significant risks, including the risk of loss of principal. Past performance is not indicative of future results.