The performance of securities mentioned within this letter refers to how the security performed in the market and does not reflect the performance attributed to the core equity portfolio. Please see the chart at the end of letter, which reflects the full list of contributors and detractors based on each security's weighting within the core equity portfolio.

For a copy of Ensemble Capital's equity strategy performance track record, please email a request to info@ensemblecapital.com.

It has now been a full year since global markets were shaken by COVID. If someone fell into a deep sleep on February 19, 2020 and woke up on March 31, 2021, they'd see the S&P 500 was up 19.72% since they last checked their portfolio. By historical standards, a great return in just over thirteen months! "Not much must have happened," they'd think, "Oh well, back to bed."

For the rest of us, we know the last year was anything but sleepy. Beyond the direct impacts of COVID, which we've covered in previous letters, the pandemic accelerated secular trends such as video gaming, remote working, and e-commerce.

As we begin lapping those impacts, the market is wrestling with what comes next for companies that prospered or struggled during COVID. The Goldman Sachs "reopen basket," which consists of 35 US-listed stocks that Goldman believes stand to benefit the most in a reopening scenario, was up 22.0% this quarter. In contrast, the Goldman Sachs "US Stay at Home Basket" of stocks was down 2.4%. Last year, the "reopen basket" was down 51.9% while the "stay at home basket" was up 0.4%. What a difference a year makes.

We saw these dynamics at play in our own portfolio. Some of the worst-performing stocks this quarter were among our best performers in Q1 2020. Netflix and Masimo were up 16.1% and 12.1%, respectively, in the first quarter of 2020 when the market was down 19.5% as they were beneficiaries of the "shelter-in-place" era. More people stuck at home meant more time watching Netflix content. Masimo's leading position in medical-grade pulse oximetry led to a surge in hospital demand for its products to provide solutions for COVID treatments. This quarter, as economies began to reopen, however, Netflix and Masimo were down 5.1% and 15.7% respectively, while the S&P 500 was up 6.4%.

Another example was the market's reaction to Costco Wholesale during the quarter. From December 31, 2020 to March 8th, Costco shares declined 17% and dropped below their pre-pandemic high. The common rationale offered by sell-side analysts was that Costco would face difficult one-year "comps" (i.e. same-store sales, which compare sales from stores open for at least a year). Because so many consumers rushed to Costco ahead of shelter-in-place and subsequent quarantines, it will be harder for Costco to meaningfully beat those results when compared year-over-year. That may indeed be true, but we struggle to understand how Costco could be "less valuable" than it was a year earlier when it concurrently increased its membership base by over 7%, or 3.9 million members. With membership renewal rates around 90%, the vast majority of the new customers Costco brought in last year will be around for years to come.

Analysts also complained about Costco raising its already industry-leading minimum wage to $16/hour, with an average "effective" pay of $23-$24/hour when you include overtime and bonuses. Costco paying its employees "too much" has been a common gripe of Wall Street analysts for at least two decades. While the extra pay does indeed impact short-term profit margins, it also serves to make Costco more durable, as its flywheel (i.e. a virtuous value cycle) starts with happy employees. A 20-year chart of Costco stock price is evidence that this strategy works and we're confident that it will continue to work.

These examples show how the market can obsess over what's at its feet rather than thinking about what's on the horizon (which, by the way, is where most of a company's intrinsic value is determined). To be sure, the long-term is made up of a bunch of short terms, but no company has a smooth trajectory up and to the right. That's why it's critical for us to build conviction in high quality businesses that add value for their stakeholders in good times and bad times. We firmly believe that Netflix, Masimo, and Costco are all stronger companies today than they were last February.

One of our best performing holdings in the first quarter, Charles Schwab & Co, offers a good example of this dynamic. The stock had underperformed the S&P 500 in recent years, as declining interest rates and the elimination of trading commissions dented profitability. As we wrote in October 2019, though, its decision to proactively "kill commissions" only fed its "flywheel of scale" and took its major competitors by surprise. Its immense scale allows Schwab to spread out expenses much wider than its competitors and its low-cost profile attracts investor assets to its platform. Its scale also provides Schwab an opportunity to launch new products and services for its large client base and gain immediate traction, while it may take an upstart years to scratch the surface.

Put differently, we've viewed Schwab as a "coiled spring" – its business fundamentals and competitive position improved while its stock price languished. Now that interest rates have started to climb, the market is beginning to recognize the huge opportunity Schwab has to better monetize the $6.9 trillion in assets held by the company. The spring is starting to uncoil, sending the stock up 23.3% over the last three months.

Notable detractors to the portfolio's returns this quarter were Masimo, Intuitive Surgical, and Ferrari, respectively.

- Masimo had a tremendous 2020, as hospital demand for medical-grade pulse oximetry monitors and sensors surged during COVID. While Masimo guided for a resumption of "normal" demand patterns in its core SET pulse oximetry business, investors were concerned about whether hospitals would fully utilize all the orders they made in 2020 and hold off on 2021 purchases. This may prove to be the case, but we think 2020 was also a transformative year for Masimo and unlocked new addressable markets in continuous monitoring, home-use of Masimo products, and new applications of their industry-leading technology. Hospitals and patients became more familiar with these new applications during COVID and we believe they will continue to gain traction in the coming years.
- Intuitive Surgical's growth slowed in 2020 as COVID hit the brakes on many elective surgeries. Given continued COVID-related risks in the US and Europe in 2021, it's still unclear as to when elective surgeries recover to more normal levels. As such, hospitals may be holding off on planned surgical robot investments until demand rebounds. That said, in Asia, where COVID has been well contained, Intuitive Surgical's procedures and systems utilizations improved, which bodes well for recovery in the US and EU. Most procedures can't be delayed indefinitely or canceled, so we continue to expect a resumption of strong, durable growth as the pandemic recedes.

- Ferrari continues to look for a CEO to replace Louis Camilleri who resigned in December after suffering from COVID. The incoming CEO would be Ferrari's third in recent years, following the untimely death of Sergio Marchionne in 2018. Nevertheless, Ferrari is in good hands with Chairman John Elkann, whose family are major investors in Ferrari and are well acquainted with the brand. Full year results were impacted by the 7-week COVID-related production suspension, which resulted in deliveries being down 10% compared with the prior year. Investors were concerned about 2021 guidance given continued worries about COVID impacts in the US and Europe and whether Ferrari will be able to hit its stated 2022 targets. But Ferrari did an amazing job maintaining production in the midst of a pandemic and we remain confident in Ferrari's potential well beyond 2022.

Notable contributors to the portfolio's returns this quarter were Home Depot, Alphabet, and First Republic Bank.

- Home Depot continued to benefit from a red-hot housing and home improvement market, delivering record financial performance in 2020. As a high return on invested capital business, any step-up in growth results in considerable shareholder value creation. While 2021 comparable sales may not yield impressive headline results, we believe there are several secular tailwinds supporting continued housing investment, including millennials entering prime household formation/peak earnings years, relatively low interest rates, and government policies.
- Alphabet (Google) handily outperformed its FAANG (Facebook, Apple, Amazon, Netflix, Google) peers in the first quarter, thanks to great fourth quarter and full-year results across the board that positively surprised the market. In particular, the non-Search businesses, such as Cloud and YouTube delivered such strong performance that investors realized they might have underestimated their longer-term revenue and profitability profiles.
- First Republic Bank revealed that despite the economic crisis in 2020, they took just $2.4 million in write downs on their loans, which rounds to 0.00%. This speaks volumes for their underwriting quality. Meanwhile, assets grew 23% and deposits were up 24% year-over-year in the fourth quarter, as First Republic continues to take market share in the lucrative high-net worth banking industry, supported by its unique corporate culture and business model that enables its bankers to focus on providing unparalleled customer service in an industry not known for it.

Beyond our portfolio activity, a lot happened in the political and macroeconomic world in the first quarter. President Biden was inaugurated in January and a few weeks later introduced a massive $1.9 trillion COVID-relief bill along with plans for an additional multi-trillion dollar infrastructure bill. These events will unquestionably impact the companies in our portfolio, some more than others. In particular, we believe our industrial-related holdings like Fastenal and Landstar, as well as home-related holdings like NVR, Home Depot, and First American Financial are well positioned to benefit from this spending.

Not many current investors have experience investing during a period of high-single digit US GDP growth and discussions of a "Roaring '20s" redux have merit. Along with promising new technologies, there's a lot to consider in terms of what might be around the corner. After more than a year of COVID-related restrictions, it's not out of the question that global consumers will want to "let loose" as they did in the 1920s following World War I and the Spanish Influenza pandemic in the late 1910s. International travel specifically seems primed to rebound after countries begin to reopen their borders to foreign travelers and we think Booking Holdings is well positioned to capitalize on the trend.

The implications of multi-trillion dollar investments into the US economy remain unclear and the biggest worry is of course inflation. In recent years, we haven't had enough inflation and the stimulus spending could help get the US economy back on the right track. Policymakers, however, will have to keep a close eye on inflation as the funds begin to flow through the economy. As far as how inflation impacts our portfolio companies, we're confident that each of our holdings has pricing power and will be able to adjust prices accordingly.

Company Focus: Fastenal (FAST) and Home Depot (HD)

Fastenal: Fastenal is a distributor of supplies to industrial manufacturing, non-residential, and other companies in the US. They make it possible to economically and efficiently move lots of daily consumable, high volume products used by employees, manufacturing facilities, and construction sites across vast distances from Asia to the US and from coast to coast.

These include heavy, low value parts like $0.02 screws and rivets (ie, the original "fasteners" business) to supplies employees use to get their jobs done like gloves, masks, safety goggles, and janitorial supplies. Its network of 2,000 free-standing company stores dotted across the country, nearly 1,300 dedicated mini-"stores" on site at customer factories, and nearly 100,000 vending machines at customer facilities create a vast embedded distribution network that physically maintain the company's relationship with its customers on a daily basis as a critical and integral part of their manufacturing operations.

In effect, a partnership with Fastenal ensures that the supplies needed by customers, are stocked on a timely and capital efficient basis. And in order to do that job well, Fastenal has to ensure it can be a reliable, efficient, (and what's now become very clear in the past year) agile procurement and inventory management partner to its customers.

That is at the heart of its value proposition; that it can get supplies customers need to keep their factories running and employees productive every day without missing a beat, at a cost that is significantly lower than the customer can do in-house while sourcing from a broad and reliable global supplier base.

If the materials needed by factories and their employees to build things aren't sufficiently stocked in the right distribution outlet, then work stops. This is obviously very disruptive and costly for the customer and would undo the customer's trust in the Fastenal partnership. Of course, the key to building and delivering on the promise of such an entrusted relationship are the employees that comprise the company's daily operations and interactions with customers, whom Fastenal constantly talks about and celebrates to show its value and commitment towards them. This is also demonstrated by the importance it places on employee safety, development, decentralized local decision making, and internal promotion and compensation policies.

That combination of dedication to its customers' mission-critical operational needs, empowering its employees, and sourcing and working with a distributed base of quality suppliers around the world has resulted in a business that has grown above industry growth rates and generated durable returns on capital for shareholders over decades.

One thing the pandemic did in the past year was test not just people's resilience around the world, but also that of companies providing essential products and services. From the start, it tested the distributed global supply chain, especially as it relates to safety supplies like disinfectants, masks, wipes, etc. Every company has been challenged to restructure its safety and health practices to ensure the safety of its employees and customers. A big part of this challenge has been to procure supplies needed to meet these goals to safely continue operations. Fastenal's globally distributed workforce was able to adapt very quickly to source and deliver needed supplies to both existing customers and many new customers.. In retrospect, the pandemic highlighted and tested Fastenal's expertise and value proposition – and the company and its employees came through with flying colors. While much of its normal business was obviously disrupted in 2020, its safety supplies business thrived and brought in new customers in new market segments to boot like healthcare, government, and education.

It's instructive to see how Fastenal was able to procure safety supplies to accommodate such a huge spike in growth of over 100% in the second quarter of 2020 when everyone else was also scrambling to source materials in short supply. In its latest annual report, the company published an interesting chart that really speaks to its sourcing agility, scale, and expertise: while 80% of safety supplies were provided by existing primary suppliers in 2019, they only accounted for 40% of the total in 2020. Since safety supplies sales grew 50% y/y in 2020, Fastenal was not only able to source new suppliers for the incremental growth but also backfill shortfalls its primary suppliers had during the year.

That resulted in a year of sales that was near the average "benchmark" year, despite disruptions in the 80% of its main line of work for industrial customers whose factories were severely impacted during the year.

Also interesting is that Fastenal has been able to continue to grow faster than the industrial market over the past decade, probably the most challenging for the industry in recent times. US industrial production has basically been in a recession since the 2009 Great Financial Crisis, having barely grown since its last peak in 2007.

Yet Fastenal grew its revenues 2.6 times from $2 billion to $5.3 billion in 2019 while maintaining operating margins of roughly 20% and returns on invested capital in the mid 20%. This comes from a combination of growing its customer base, expanding beyond its traditional industrial segment, and increasing the value it provides customers by deepening its relationships and value-added procurement services (onsite stores and factory placed vending machines and bin stocking technologies), thereby taking greater share of customers' cost wallet. Yet, $5 billion is still a small share of the $100+ billion sourcing opportunity available ahead to grow into for decades to come.

Looking forward, the industrial economy looks poised to accelerate. The combination of unprecedented direct stimulus to consumers, untapped cash in the form of an atypically high savings rate over the last year, a strong pick up in GDP growth, strong growth in the housing economy, and strategic reshoring of manufacturing could all serve to accelerate the industrial economy from its decade long torpor. That would be a big tailwind to Fastenal's base of existing businesses, even as it continues to grow its share of customers.

Home Depot: The big orange sign of Home Depot is a familiar sight for homeowners across the country. Despite the rise of Amazon, Home Depot has generated outstanding results for shareholders during the rise of eCommerce, even as Home Depot's end market in housing suffered the worst collapse in a century. Over the last fifteen years, a period which began at the peak of the housing bubble, Home Depot's stock has generated annual returns of 17% a year, outperforming the S&P 500 by approximately 7% a year.

But while homeowners can attest to their continued shopping at Home Depot, they may not be aware that only about half the company is dedicated to serving Do It Yourself homeowners, with the other half acting as a key supplier to small contractors – which the company calls Pros – who depend on Home Depot as a mission critical business partner.

While the company does not report on their contractor business separately from their homeowner business, they have regularly offered comments indicating that contractors make up just 4% of their customer base, but about 45% of revenue. Basic math implies that this means the average contractor customer spends about twenty times the amount that the average homeowner customer spends. In an industry where you want to drive high levels of sales per store, the contractor customer profile is super attractive. It is Home Depot's focus on and success in serving contractors that has led to them generating about 30% more revenue per store than competitor Lowe's which has far fewer professional contractor customers.

Therefore, we think about Home Depot as two different businesses built on top of a single operational platform that allows them to better leverage their cost structure. This has led the company to generate returns on invested capital of about 45%, putting them top tier of high return on capital retailers.

Everyone likes growth, but one way to think about companies like Home Depot that generate high returns on invested capital is that these businesses can grow without needing to invest as much in their business to generate any given level of growth compared to companies with lower returns on capital. In the case of Home Depot, their success in growing the business without needing to invest that much to do so is well illustrated by the fact that over the last decade, the number of stores they operate has only increased by 2%, even while revenue has nearly doubled.

On the Pro side of their business, Home Depot is the first choice for small contractors who are not large enough to buy directly from distributors at the scale required to get discounted pricing. If you own a house and have had a contractor do some sort of work, you are familiar with the way that most every job ends up needing some part or tool that the contractor does not have on hand. In this circumstance, the contractor wants to make as time efficient of a trip as possible to go pick up the part and complete the job. Since the contractor passes along the cost of parts to the homeowner, it is the efficiency with which Home Depot is able to get them back to the job site and working, rather than the lowest possible price for the part, that drives the contractor's shopping behavior. In fact, a number of contractors we've talked to describe driving past a Lowe's to get to a further away Home Depot store because it is their preferred supplier.

Home Depot has also invested heavily in their online capabilities. Truly an "omnichannel" retailer that strives to be able to serve both Pro and Do It Yourself customers via in store shopping, online delivery, or curbside pickup, the company has been held up by Google's Cloud services group as a case study of a data driven retailer using modern data and analytics to drive results.

Of course, when competing with Amazon, having a strong eCommerce or Omnichannel strategy is just table stakes. But due to the nature of home improvement spending, where parts are often needed the same day and in many cases are heavy, bulky objects, the fact that well over 50% of Home Depot's online orders are picked up in store, despite offering 2-day delivery to 90% of US households, speaks to the unique nature of this category and why we do not view Amazon as a meaningful threat.

While the company has been able to drive growth without building many new stores, they have indeed invested aggressively into three core areas. They've invested into their existing stores to keep them up to date and efficiently run. They've invested in technology, such as a mobile app that can locate a part in a given store and guide you directly to the aisle it is on. And importantly, they've invested in their supply chain, warehouses, and delivery capabilities to allow them to thrive in an omnichannel world. Unlike many retailers who still manage their online offering as a separate division, Home Depot operates as a single company, with a single supply chain, and simply offers different means for customers to shop their single set of inventory.

Their Pro Online investments have been of particular note, given it is with their Pro customers that their offering is most differentiated. The company talks about Pro Online as a "platform for Pros to build their business." While Amazon, like most consumer facing online retailers, offers the same user interface for consumers and business customers, Home Depot recognizes that the needs of their Pro customers are fundamentally distinct from homeowners.

For instance, their Pro Online interface allows for the exporting of order history to Quickbooks, the accounting software used by most small contractors, and makes it easy to manage delivery options to a large number of active job sites. If you go into a typical consumer online shopping site and try to ship items to multiple addresses other than your own, you'll quickly trigger a fraud alert. But while this behavior is atypical for consumers, it is standard behavior for Pro contractors who appreciate that Home Depot understands how they operate.

While Pro customers have gone from making up 30% of revenue a decade ago to 45% today, there is meaningful opportunity still ahead. According to the company, 70% of Pro customers never visit the dedicated Pro desk at the store. But when Home Depot is able to identify these contractor customers and engage with them at the Pro Desk or other Pro services, their annual spending quickly doubles on average.

While Home Depot has executed extremely well over the last decade, it did so in the context of a weak overall economy, the worst housing crash in a century, an existing base of homes that had more new homes (needing less home improvement work) than the historical average, and low or even negative equity restricting homeowners' ability to finance home improvement projects. But we believe the housing end market is in the midst of a Great Reshuffling.

While Home Depot generated solid 5% annual revenue growth during the decade between the end of the housing crash and the beginning of the COVID pandemic, it is important to note that the Do It Yourself homeowner segment grew at about 3% a year, while the Pro segment serving contractors grew at 9% a year. We believe that the low growth of Do It Yourself sales was related to the depressed housing activity that characterized the last decade, but is now in the midst of reverting to more normalized activity levels. The faster growth in the contractor segment on the other hand was due to them taking material market share and building a better set of services for Pro customers. Thus, this segment grew nicely despite the low levels of housing activity and will benefit further from a reversion to more normalized home improvement activity.

As Americans emerge from the pandemic, they will be reevaluating their housing needs. Remote work options may cause more homeowners to consider moving, with home improvement projects being common in preparation for sale as well as when a new family first moves into a house. Many people who do not move will still plan to work from home with some regularity, driving demand to create office space in their house with associated remodeling expenditures.

Home Depot is firing on all cylinders. They did right by their employees during the pandemic, remaining open as an essential business, spending $2 billion in increased pay and bonuses, half of which they have decided to make permanent. While 2021 will face difficult comparisons to last year's off the charts home improvement spending due to home owners being stuck in their homes during shelter in place, we think Home Depot has an extremely promising decade ahead.

Disclosures

2021 Q1 Contributors and Detractors to Absolute Return Data

Description	Symbol	Average Weight	Contribution (Gross)	Contribution (Net)	Description	Symbol	Average Weight	Contribution (Gross)	Contribution (Net)
Home Depot, Inc.	HD	8.25%	1.24%	1.22%	Starbucks Corp.	SBUX	3.15%	0.09%	0.08%
Alphabet, Inc. Class-A	GOOGL	6.87%	1.11%	1.09%	Fastenal Co.	FAST	2.04%	0.07%	0.06%
Charles Schwab Corp.	SCHW	4.99%	1.06%	1.05%	Broadridge Financial Solutions, Inc.	BR	3.34%	-0.03%	-0.04%
First Republic Bank	FRC	5.76%	1.00%	0.99%	Heico Corp. Class-A	HEI/A	1.63%	-0.07%	-0.07%
NVR, Inc.	NVR	4.69%	0.69%	0.68%	Costco Wholesale Corp.	COST	1.95%	-0.11%	-0.11%
Landstar Systems, Inc.	LSTR	2.40%	0.51%	0.50%	Netflix, Inc.	NFLX	9.10%	-0.34%	-0.36%
First American Financial Corp.	FAF	3.29%	0.34%	0.33%	Blackline, Inc.	BL	1.83%	-0.35%	-0.35%
Booking Holdings, Inc.	BKNG	4.69%	0.22%	0.21%	Nintendo Co LTD	NTDOY	3.49%	-0.41%	-0.42%
Paychex, Inc.	PAYX	2.79%	0.22%	0.21%	Ferrari NV	RACE	4.96%	-0.50%	-0.51%
Chipotle Mexican Gril, Inc.	CMG	2.12%	0.14%	0.13%	Intuitive Surgical, Inc.	ISRG	5.90%	-0.56%	-0.57%
Illumina, Inc.	ILMN	3.36%	0.13%	0.12%	Masimo Corp.	MASI	4.96%	-0.71%	-0.72%
Mastercard Inc. Class-A	MA	8.24%	0.13%	0.11%					

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities listed above. The performance information shown above has been calculated using a representative client account managed by the firm in our core equity strategy and represents the securities held for the quarter ended 03/31/2021. The individual quarterly net contribution to returns are calculated by reducing the gross contribution to return by 1/4 of the weighted average of the firm's highest management fee, which is 1.00% per year. Information on the methodology used to calculate the performance information is available upon request. The performance shown in this chart will not equal Ensemble's composite performance due to, among other things, the timing of transactions in Ensemble's clients' accounts.

ADDITIONAL IMPORTANT DISCLOSURES

Ensemble Capital is an SEC registered investment adviser; however, this does not imply any level of skill or training and no inference of such should be made. The opinions expressed herein are as of the date of publication and are provided for informational purposes only. Content will not be updated after publication and should not be considered current after the publication date. We provide historical content for transparency purposes only. All opinions are subject to change without notice and due to changes in the market or economic conditions may not necessarily come to pass. Nothing contained herein should be construed as a comprehensive statement of the matters discussed, considered investment, financial, legal, or tax advice, or a recommendation to buy or sell any securities, and no investment decision should be made based solely on any information provided herein. Ensemble Capital does not become a fiduciary to any reader or other person or entity by the person's use of or access to the material. The reader assumes the responsibility of evaluating the merits and risks associated with the use of any information or other content and for any decisions based on such content.

All investments in securities carry risks, including the risk of losing one's entire investment. Investing in stocks, bonds, exchange traded funds, mutual funds, and money market funds involve risk of loss. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be profitable or suitable for a particular investor's financial situation or risk tolerance. Some securities rely on leverage which accentuates gains & losses. Foreign investing involves greater volatility and political, economic and currency risks and differences in accounting methods. Future investments will be made under different economic and market conditions than those that prevailed during past periods. Past performance of an individual security is no guarantee of future results. Past performance of Ensemble Capital client investment accounts is no guarantee of future results. In addition, there is no guarantee that the investment objectives of Ensemble Capital's core equity strategy will be met. Asset allocation and portfolio diversification cannot ensure or guarantee better performance and cannot eliminate the risk of investment losses.

As a result of client-specific circumstances, individual clients may hold positions that are not part of Ensemble Capital's core equity strategy. Ensemble is a fully discretionary adviser and may exit a portfolio position at any time without notice, in its own discretion. Ensemble Capital employees and related persons may hold positions or other interests in the securities mentioned herein. Employees and related persons trade for their own accounts on the basis of their personal investment goals and financial circumstances.

Some of the information provided herein has been obtained from third party sources that we believe to be reliable, but it is not guaranteed. This content may contain forward-looking statements using terminology such as "may", "will", "expect", "intend", "anticipate", "estimate", "believe", "continue", "potential" or other similar terms. Although we make such statements based on assumptions that we believe to be reasonable, there can be no assurance that actual results will not differ materially from those expressed in the forward-looking statements. Such statements involve risks, uncertainties and assumptions and should not be construed as any kind of guarantee.