GFI Investment Counsel Ltd.

Preserving and growing family capital™

"No one buys a farm based on whether they think it's going to rain next year or not."
Warren Buffett, Berkshire Hathaway 2018 Annual Shareholders Meeting

Second Quarter 2018 Commentary

Good Opportunities Fund

The Fund generated a return of 3.7% for the second quarter and 5.2% over the first six months of 2018.

Apple for Spirit

During the second quarter of 2018, we sold Spirit Airlines, Inc. ("Spirit") and purchased Apple Inc. ("Apple") in the Fund. Spirit is an ultra-low-cost ("ULC") airline that operates across the United States and Central America. Its main advantage is the fact that its competitors' costs are roughly 70% higher than Spirit's costs. This significant cost advantage lets Spirit price its tickets lower than the competition, while still generating excellent returns on capital.

The low-cost ("LC") airline business model was started in the U.S. by Southwest Airlines several decades ago. Ryanair copied that business model in Europe, but went even further in cutting costs, which created the ULC business model. The LC/ULC business models have generated very strong returns over the years. Both Southwest and Ryanair have generated approximately 20% annual returns since these companies' initial public listings.

When investing in Spirit, our biggest mistake was comparing that company to those other two successful pioneers. Southwest and Ryanair were largely able to take the legacy airline competitors by surprise with their new business models many decades ago. Back then, the legacy airlines were suffering as a result of labour issues and broken business models, and the industry had undergone multiple bankruptcies. The legacy airlines learned the hard way the threat that the ULC airline model posed to their survival.

The element of surprise no longer existed when we invested in Spirit. The large legacy carriers responded by matching Spirit's prices on shared routes. On a wider scale, if a smaller, lower-cost company operates only in Chicago, while the larger competitor operates nationwide, the larger competitor can afford to strategically keep losing money in Chicago to put financial pressure on the

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low-cost company and restrain its ability to grow. Additionally, the strong economy has allowed large incumbents to charge business travellers higher prices, mitigating the impact of the lower-cost seats sold to compete with Spirit.

The strategic foresight of the large incumbents has made it very difficult to forecast the competitive situation five and 10 years into the future. No longer possessing the stability, predictability and consistent earnings growth profile we look for, we decided to exit the investment in Spirit and take advantage of the opportunity to buy a wonderful business called Apple.

While buying Apple a decade ago would have been prophetic, we are very excited about the future growth that Apple services will have to the company's bottom line. Today, the majority of Apple's profits stem from the iPhone. Its main competitor is Android, an open license operating system available on smartphones from multiple manufacturers.

Once a consumer chooses between an Apple or Android device for their first smartphone (or has their parents choose for them), the user starts to accumulate data, buy apps, get accustomed to the user interface, and subscribe to music and other services. As time passes, it becomes statistically less likely the user will switch devices due to a combination of lethargy and the time it would take to move data to – and educate themselves on – a new operating system. This is why Apple and Android both have retention rates of 80%, which is very high for a consumer product. In fact, most switching occurs in the first few years of ownership, when learning costs are still minimal. The longer a consumer uses an iPhone or an Android device, the longer they are likely to remain loyal to that brand.

While Apple's iPhone sales have stabilized, growth lies in selling additional services to this sticky consumer. As consumers spend an increasing amount of time on their phones, a larger percentage of their spending activity takes place on their device. Transactions using Apple Pay, app purchases from the App Store, Apple Music, iCloud data storage, gaming, etc. all contribute to Apple's bottom line on a growing basis. In cases where a transaction is on behalf of a third party, Apple charges a 15%-30% commission and the revenue on this service is very high margin, with each additional transaction often exhibiting no additional cost. As smartphones continue to replace PCs for consumer transactions, we think this is a dependable source of long-term revenue and high-margin profit growth for Apple. The hardware's embedded consumer base is so valuable that Google reportedly pays Apple several billion dollars per year to make Google the default search engine on the iPhone. High margin indeed.

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Unlike Spirit, Apple has a loyal customer base and predictability of future cash flow. We are excited to be fractional owners of this wonderful business.

Thank you for believing in our common-sense approach to investing. We are always available if you have any questions or concerns.

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