January 24, 2022

Banyan's equity composite gained 25.2% in 2021 compared to the S&P 500's total return of 28.7%. The year was a tale of two markets. Our portfolio gained 18.6% in the first half of the year versus the S&P 500's gain of 15.3%. Then the tides turned. We gained a mere 5.6% in the second half of the year while the S&P 500 gained 11.7%. Mr. Market can be a fickle servant.

But a servant he is nonetheless. Every day, Mr. Market is at your doorstep, hat in hand, offering to buy or sell stock in countless businesses. He is usually a sensible man, but he can be bipolar with emotions that swing between ecstasy and depression. For those that make Mr. Market their servant, his emotional volatility is most endearing. It is the downfall of those that make him their master.

Warren Buffett made this point in his 1987 letter to Berkshire Hathaway shareholders. He wrote,

> "[L]ike Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice: Mr. Market is there to serve you, not to guide you. It is his pocket book, not his wisdom, that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence."

Later in the letter, Buffett reveals the secret to making Mr. Market serve you. He urges readers to heed the advice of Benjamin Graham, who said, "In the short run, the market is a voting machine but in the long run it is a weighing machine." In other words, remember that it is the weight of economic substance that matters in the end; a stock's price gyrations in the interim matter not.

With Buffett and Graham's wisdom in mind, let us weigh the economic substance of our portfolio and "the market." Thanks to the generosity of the Georgia State College of Law, we had free access to a Bloomberg Terminal, which is a well-respected source of financial information. Without this resource, calculating financial metrics for the S&P 500 as a whole would be overly burdensome.

According to Bloomberg data, if Banyan's portfolio and the S&P 500 were each a single company, they would have the following characteristics:

(Weighted Average)	Return on Capital, 5 Yr. Avg.[1]	TTM Revenue Growth[2]	TTM Free Cash Flow Yield[3]
Banyan's Portfolio	12.2%	17.6%	7.1%
S&P 500 Index	7.6%	12.5%	3.3%

The above metrics, like all financial metrics, have shortcomings. We must compare apples-to-apples, however, and these metrics were available for our portfolio and the S&P 500 as a whole.

Now, what can we deduce from the above metrics?

1. **Return on Capital** | In their never-ending quest for wealth, entrepreneurs seek business opportunities promising high returns on capital. This motivates them to replicate successful businesses. The competition spurred by such entrepreneurial behavior erodes the returns earned by an incumbent absent a competitive advantage making replication of the business difficult. Thus, sustaining a high return on capital is evidence of a competitive advantage, or "economic moat." Based on Bloomberg's calculation of return on capital, our portfolio of businesses earned a 60% higher return than the businesses in the S&P 500.

2. **Revenue Growth** | Owning a business earning high returns on capital is advised regardless of its ability to grow because it indicates a competitive advantage and, thus, stability, but a high return on capital is particularly attractive if the business is also capable of growing. It allows the business to reinvest its earnings at a much higher rate of return than what is available to us in financial markets, which effectively outsources the job of compounding to those with a better opportunity set. Over the last twelve months of reported data, our businesses have grown at a faster clip than the businesses in the S&P 500.

3. **Free Cash Flow Yield** | Simply identifying and buying great businesses is not enough. It is critical that an investor not overpay for them, which brings us to valuation. Our preferred valuation metric is "earnings power yield," or a business's earnings capacity divided by its market value. This metric is subjective and, thus, not easily comparable to the S&P 500. A more objective substitute is "free cash flow yield," or the unrestricted cash a business generates divided by its market value. Over the last twelve months of reported data, our businesses' free cash flow yield was more than twice that of the S&P 500 at yearend prices.

We would never advise investing based solely on backward looking financial metrics, especially any three alone. These metrics do convey important information, however, and they provide an objective way to measure the weight of economic substance underlying our portfolio and the S&P

[1] We used the last five fiscal years of data to smooth volatility. "Return on capital" is calculated differently depending on the type of business. For non-financial businesses, the metric is calculated by dividing after-tax operating income by average total capital invested. For financial businesses, the metric is closer to a return on equity measurement. See a Bloomberg Terminal for more details.

[2] "Revenue growth" is calculated by dividing the last twelve months of reported revenue by the revenue reported in the twelve months prior. For most businesses, the trailing twelve months of data ended on September 30, 2021.

[3] "Free Cash Flow Yield" is calculated by dividing the last twelve months of reported free cash flow by the business's market value on December 31, 2021. For most businesses, the trailing twelve months of free cash flow data ended on September 30, 2021.

500. Furthermore, there is no reason to believe these metrics unfairly flatter our portfolio, although both our portfolio and the S&P 500's growth rates benefited from a pandemic rebound in 2021.

Taking the above metrics at face value, then, the scales of value appear to be tilted heavily in our favor. Relative to the S&P 500, our businesses earned a higher return on capital, grew at a faster clip, and yielded over twice as much free cash flow at yearend prices. This suggests our businesses are of higher quality than "the market" and trade at much cheaper valuations.

It is for this reason that we lack a strong opinion on "the market" generally. Nor do we care much what Mr. Market thinks of our businesses' values quarter-to-quarter or year-to-year. Our concern is the weight of economic substance underlying the 15-20 stocks in your portfolio. Economic substance, after all, is the only basis of ***permanent wealth***. Wealth is illusory in its absence.

Sincerely,

Drew

Drew Estes, CFA
Partner & Portfolio Manager

Alek

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