

# Chapman Investment Management

*Delivering financial peace of mind  
with trust and integrity.*



**CHAPMAN**  
Investment Management, LLC





## Peace of Mind and Superior Performance

*“Financial peace of mind delivered  
with uncompromising integrity and  
a consistent investment process built  
upon quality and value.”*

Chapman Investment Management, LLC is a registered investment advisory firm that provides professional portfolio management for individually-managed taxable and retirement accounts. Scott Chapman, CFA has over 25 years of experience successfully managing portfolios in bull and bear markets with a long-only strategy.

Our goal is to provide financial peace of mind for our clients by delivering superior investment performance and exceptional personalized client service. We plan to preserve and grow capital by applying a proven, time-tested investment process that identifies high-quality businesses with sustainable competitive advantages led by shareholder-oriented management teams, and investing when the stock prices are priced below intrinsic value. We achieve superior client service by understanding investment objectives, maintaining regular communication, and being responsive to changing investment needs.

*How Chapman Investment Management, LLC is different  
from other investment management firms:*

- Designed and successfully implemented an investment process that has been consistently applied for over 20 years with superior performance and less risk
- Focuses on business fundamentals, cash flow, and intrinsic value (not macro headlines)
- Conviction gained from intensive hands-on primary research
- Views stocks as ownership of a business and management as partners
- Manages risk through disciplined emphasis on valuation of high-quality companies
- Long-term perspective with low turnover
- Concentrated all-cap portfolio
- Opportunistic investment approach; not locked into a style-box
- Bias toward “tollgate” businesses with recurring revenues, large competitive moats, and high ROIC (return on invested capital)
- 100% owned business; interests directly aligned with client’s
- Decisions not made by committee



*“Investing is a marathon that requires focus on the ‘long run,’ disciplined practice, and perseverance to stay the course. The rewards are well worth it.”*



## Investment Philosophy

Chapman Investment Management’s objective is to preserve and grow invested capital by seeking high-quality, proven growth companies whose securities are undervalued by the market. These companies typically have free cash flow and sustainable competitive advantages that produce superior returns, and are led by a trusted and shareholder-oriented management team.

*Our investment philosophy is grounded in seven guiding principles:*

1. Capital Preservation
2. Quality Holdings
3. Long-term Perspective
4. Embrace Stocks as Business Owners
5. Concentrated Portfolio
6. Low Turnover
7. All-cap Flexibility



# 1. Capital Preservation

Our first investment priority is to preserve your capital. The first step in making money is to not lose it. We understand that in order to break even after a 50% loss, an investor has the daunting task of doubling their return, which could take years. Warren Buffett famously stated his basic rules for investing: “Rule No. 1: Never lose money. Rule No. 2: Never forget Rule No. 1.”

We preserve capital by managing risk, and two risks in particular: business risk and price risk. Business risk is the risk that a company’s competitive advantage will erode or be lost altogether, causing a permanent loss of capital and intrinsic value. Recent examples include the loss in pricing power of branded products due to private label competition, the decline in subscription of newspapers, magazines and cable due to online content, the substitution of email for postal service, and the threat to physical retailers from cheaper warehouse clubs and online retailers such as Amazon. A company’s competitive landscape demands constant vigilance.

Price risk is the risk that an investor overpays for a sound company. We minimize price risk by conservatively estimating a company’s intrinsic value, and buying stock when the price is at an adequate discount to its value. This is our margin of safety. When we buy each stock with a margin of safety, downside risk protection is built into the overall portfolio.

Additionally, we prudently diversify with 15-25 companies, have no more than two companies in the same industry, and no more than double S&P 500 sector weights in the portfolio.

*“We understand that in order to break even after a 50% loss, an investor has the daunting task of doubling their return, which could take years.”*





## 2. Quality Holdings

Quality can mean different things to different people; some say you know it when you see it. In art there is Rembrandt and Monet, in jewelry there is Tiffany and Cartier, in watches there is Rolex, and in automobiles there is Rolls Royce. These products and brands have achieved a unique market advantage that has enduring value. We look for similar enduring quality attributes in the businesses we invest.

Quality businesses are those having sustainable competitive advantages that are difficult for a competitor to replicate. Competitive advantages include patent protection (pharmaceutical and biotech drugs), trusted brands with great customer goodwill (Disney), regulatory licenses (Moody's), high switching costs (banks), cost advantages (Costco), scale/size advantage (Coca-Cola), and a network effect (Facebook). Companies that have earned a competitive advantage and can sustain that advantage over time typically generate high returns on invested capital (ROIC equals cash income divided by debt and shareholders equity) and prodigious cash flow, and can be wealth generating and compounding machines.

Many of our portfolio companies have a ROIC over 20%, which substantially exceeds the average cost of capital of 10%, and consequently, these companies generate free cash flow and shareholder value. The ideal quality business would have a durable competitive advantage, high ROIC and free cash flow with little to no debt, a shareholder-minded management team of high integrity, and a "tollgate/repeat purchase" predictability to its business.

We have a healthy skepticism about reported earnings, which can be manipulated with accrual accounting to appear higher than the actual cash generated by the business and is a red flag. In April 2001, I visited Enron management at their Houston headquarters to understand how the company could report years of *positive* income, but have a *negative* cumulative five-year free cash flow and pay almost no taxes. Enron was then a popular energy services company with a \$70 billion market valuation. I left without an adequate explanation and thereby avoided a potential loss since the company filed for bankruptcy eight months later.

## On Selectivity

*"We look for companies that have achieved a unique market advantage. Quality businesses are those having sustainable competitive advantages that are difficult for a competitor to replicate."*



### 3. A Long-term Perspective

In the short-term, stock prices may react to current events, such as world political news, currency devaluations, central bank changes in monetary policy, rumors, changes in sell-side analyst recommendations, forced selling by mutual funds experiencing redemptions, trading by momentum-driven speculators, short covering, option expirations, quarter-end window dressing, and computer-driven block trades. These factors may have little to do with a company's intrinsic value, but may present opportunities to take advantage of temporary differences between market valuation and inherent value. In the long-term, stock prices correlate closely with a company's earnings and cash flow. For instance, in the ten-years ending August 2014, Walt Disney's earnings grew 15% annually on average and the stock returned 15% annually.

Our focus is on a company's long-term earnings prospects, and we prefer that our investment performance be measured over at least a five-year period. The heart of Sir John Templeton's stock picking method was to favor stocks that had the lowest stock price relative to his five-year earnings forecast. Warren Buffett prefers to be measured over a rolling-five year period and has said that he wants to have a reasonably good idea of what a company will earn in ten years. Peter Lynch said that you might as well flip a coin to decide if stocks will be higher or lower in two to three years, but that stocks are relatively predictable over twenty years. While one cannot forecast five-year forward earnings with 100% accuracy, the earnings-based analytical process focuses on the right variables, such as the durability of a company's competitive advantage and the predictability of the business.

The long-term earnings forecast process also distinguishes us from many sell-side analysts, who seldom forecast beyond two years, and from many investors who simply bet on whether a company will beat consensus earnings estimates for the next quarter. Our goal is to outperform the market average over time.

*“In the long-term, stock prices correlate closely with a company's earnings and cash flow. Our goal is to outperform the market average over time.”*





## 4. Embrace Stocks as Owners

The barriers to owning a stock are low, but the barriers to understanding a business, its competitive advantages, risks, and value, are high. With a few online clicks and adequate funds, one can buy a stock in a fraction of a second. But becoming a long-term investor, as opposed to a short-term market trader, one must know the company and the reasons for owning the company. Without this hard-won knowledge, one cannot withstand the inevitable headwinds that tempt the uninformed to sell with the crowd. Fear-induced selling based on misinformation locks in poor results.

A long-term investor understands the difference between a company's intrinsic value and the market price of the stock. It is not uncommon for a stock price to vary by as much as 50% from its high and low during a year, and we try to capitalize on the disconnect between the relatively stable intrinsic value and the more volatile stock price. We view owning a stock as a partnership with management and expect management to communicate and behave accordingly. While we monitor stock prices daily, once we purchase a stock, our focus is on the business fundamentals and ensuring that our investment rationale and intrinsic value analysis remain sound.

## On Partnership

*“We view owning a stock as a partnership with management. Our focus is on the business fundamentals and ensuring that our investment rationale and intrinsic value remain sound.”*





## 5. A Concentrated Portfolio

Our portfolios typically own between 15-25 companies, with no more than two companies in the same industry. This selective approach has several advantages.

First, our winners can make a significant contribution to performance. Our experience has been that first-class businesses bought at compelling price discounts to intrinsic value can generate superior portfolio returns with less risk. Truly outstanding business gems are not usually on sale, but when they are, we want them to impact performance. Imagine Babe Ruth's impact to a Yankees game if he had to wait his turn to bat once all the other starters and benchwarmers had their turn at the plate.

Second, we can leverage our research with our best ideas and avoid diluting our time following companies that merely occupy space in a portfolio. Lastly, our concentrated positions and longer holding periods lead to a more constructive dialog with management as they can see by our strategic questions and actions that we really are business partners.

*"Superior quality businesses are not commonplace.  
We concentrate on owning only the best."*







## 6. Low Turnover

Our turnover is low, and our emphasis on the long-term leads to holding periods of several years. A 20-25% turnover rate in a portfolio means that we hold stocks on average about 4-5 years. This means that we only require about 4-5 new ideas each year. We can be patient and wait for Mr. Market to throw the fat pitch in the middle of the strike zone before swinging.

This is in contrast to the average mutual fund portfolio that has 100% turnover, often with at least 100 stocks. This means that the portfolio manager each year faces the daunting responsibility of analyzing 400 quarterly earnings reports and conference calls, monitoring the competitive advantages of 100 companies and their competitors, and finding 100 replacement ideas.

The “buy and hold” strategy allows us to enjoy the compounding benefits of superior growth companies, and minimize the commissions and taxes that are obstacles to growing capital. We note that the majority of the Forbes 400 wealthiest have earned their place on the list by owning outstanding businesses held for many years.

## On the Virtue of Patience

*“Buying a business that is undervalued for temporary reasons, requires time and patience to realize its full investment potential.”*



## 7. All-cap Flexibility

Our portfolios are not defined by company size and market capitalization. We value the flexibility to select first-tier businesses led by all-star managers at attractive prices, regardless of the size of the company.

We are not encumbered by the amount of our assets under management or by an arbitrary “style-box.” Many money managers have a mandate to stay within their defined style-box of, for instance, large-cap growth, even if large-cap growth stocks are overpriced. This is a by-product of the desire of the money management company with multiple style-boxes to be able to market whichever style-box happens to be in vogue. We manage your portfolio as though all of our own capital were similarly invested to capitalize on maximum opportunities.

*“Our portfolios are not defined by company size and market capitalization. We value the flexibility to select first-tier businesses led by all-star managers at attractive prices, regardless of the size of the company.”*





JOHN WOODEN  
FORMER UCLA BASKETBALL COACH

*“Success is peace of mind, which is a direct result of self-satisfaction in knowing you made the effort to become the best you are capable of becoming.”*



CHAPMAN  
INVESTMENT PROCESS

## The Investment Process

### BACKGROUND

Our investment process is clearly defined, consistently applied, rooted in proven and timeless investment principles, and is a process that has delivered excess returns with less risk.

Warren Buffett said, “If I have seen further than others, it is because I have stood on the shoulders of giants.” The giants he referred to were successful investors such as Ben Graham, Phil Fisher, Phil Carret and Charlie Munger.

In my quest over twenty years ago for adopting best practices from giants of the investing world, I chose three investors who demonstrated success over decades; Sir John Templeton, Peter Lynch and Warren Buffett. For each investor, I studied their investing process with a special emphasis on case studies of their winning stocks. The case studies blended the master’s rationale for buying specific stocks as described by them in subsequent interviews, with prevailing news and popular opinion at the time of their successful investments. Combining the historical context of company developments with their rationale formed lasting insights and interesting common threads. These common threads became the fabric of the Chapman Investment Management investment process, called The Pyramid of Growth.

The Pyramid concept was borrowed from the Pyramid of Success which was developed by the beloved former UCLA basketball coach John Wooden, whom ESPN named Coach of the Century. Coach Wooden’s Pyramid of Success, is a format with which he illustrated the qualities necessary for individual and team success. Each block of the Pyramid represents a behavior, attitude, value and quality ingredient for success, including enthusiasm, industriousness, self-control, poise, confidence and competitive greatness. Ultimately he defined success as “peace of mind which is a direct result of self-satisfaction in knowing



## The Investment Process *(cont.)*

you made the effort to become the best you are capable of becoming.” Coach’s Pyramid and definition of success inspired me when I first discovered them by reading his book, *They Call Me Coach*, when I was a freshman in high school. They have guided me ever since, particularly as I had the honor of personally knowing Coach in the last eight years of his life. The Pyramid of Growth process produced a top performing five-star ranking by Morningstar rating service for mutual funds that I managed or co-managed at two of my predecessor firms. Well executed, The Pyramid of Growth is designed to provide financial peace of mind by participating in the success of companies with enduring quality and compounding growth.

### INVESTMENT STRATEGY

Our strategy is to build a portfolio of outstanding companies possessing sustainable competitive advantages with high returns on capital and free cash flow, preferably with little to no debt, at a price that is a discount to their intrinsic value. We agree with Warren Buffett that it is far better to own a wonderful business at a fair price than a fair business at a wonderful price. It is even better to own a wonderful business at a wonderful price.

### SOURCE OF IDEAS

The cost of convenient access to data in today’s “Google search” society is information overload. The challenge is not accessing information; but converting information to timely insights and actionable knowledge that builds wealth. We obtain our investment candidates from a variety of sources, including discussions with company executives about their respected competitors, customers, suppliers and distributors. Ideas also come from reading the general business press, trade journals, colleagues in the industry, and data rich sources such as Value Line. We are interested in proven wealth building companies



that have a secular tailwind and competitive advantage where we can participate in the compounding of their sustainable growth for many years. We are not interested in unsustainable growth commonly seen in companies that have low barriers-to-entry, are heavily regulated, dependent on unpredictable commodities, vulnerable to heavy cycles of capital intensity, or have short product life cycles. We may occasionally consider turnaround candidates where we are clearly convinced that the strategic path to prosperity is achievable, the financial firepower is strong, and management has credibility based on their previous track record of success. Once a viable investment candidate is identified, it is then filtered with the criteria in the Pyramid of Growth.

### THE DUE DILIGENCE PROCESS

A ball club manager is responsible for continually evaluating the fundamental performance of each starting player and the compatibility of possible replacement candidates to best position the club to win. Likewise, Chapman Investment Management, LLC focuses on evaluating the fundamental business performance and cost/benefit of its “starting lineup” and possible replacement candidates, assured that the scoreboard will take care of itself. We may not win every game, but over time we enhance our probability for success with a consistent discipline of evaluating business quality, management excellence, and value.

The essence of our due diligence process is the time-tested filter of our Pyramid of Growth. In its simplest form, the Pyramid of Growth criteria assesses the quality and durability of the business and its risks, the excellence of management, and whether the market price is attractive compared to the company’s intrinsic value. If the company meets these tests, then we evaluate whether it is a better substitute for an existing position in the portfolio.





## The Pyramid of Growth

*The Pyramid of Growth includes these criteria to determine if the business is high-quality and has a sustainable competitive advantage:*

- **A BUSINESS WE UNDERSTAND, PREFERABLY A TOLLGATE**

Tollgate businesses have recurring revenues with repeat transactions that enhance earnings predictability and allows for more accurate intrinsic value estimates. Companies that have recurring revenues are “all-weather” companies that deliver consistent results despite weak economies.

- **SUSTAINABLE COMPETITIVE ADVANTAGE**

Competitive advantages that are long-lasting create enduring value. Examples include patent protection, trusted brands, regulatory licenses, high switching costs, cost advantages, scale/size advantage, and a network effect. Evidence of competitive advantages include a low threat of new entrants, little threat of substitution, strong bargaining power over customers and suppliers, and minimal rivalry among competitors.

- **HIGH BARRIER TO ENTRY WITH STRONG BRANDS**

Trusted brands can be a company’s most valuable asset and create customer loyalty. Customer loyalty generates repeat sales which are more profitable than the cost of attracting new customers. We prefer one-of-a-kind businesses with no close substitute.

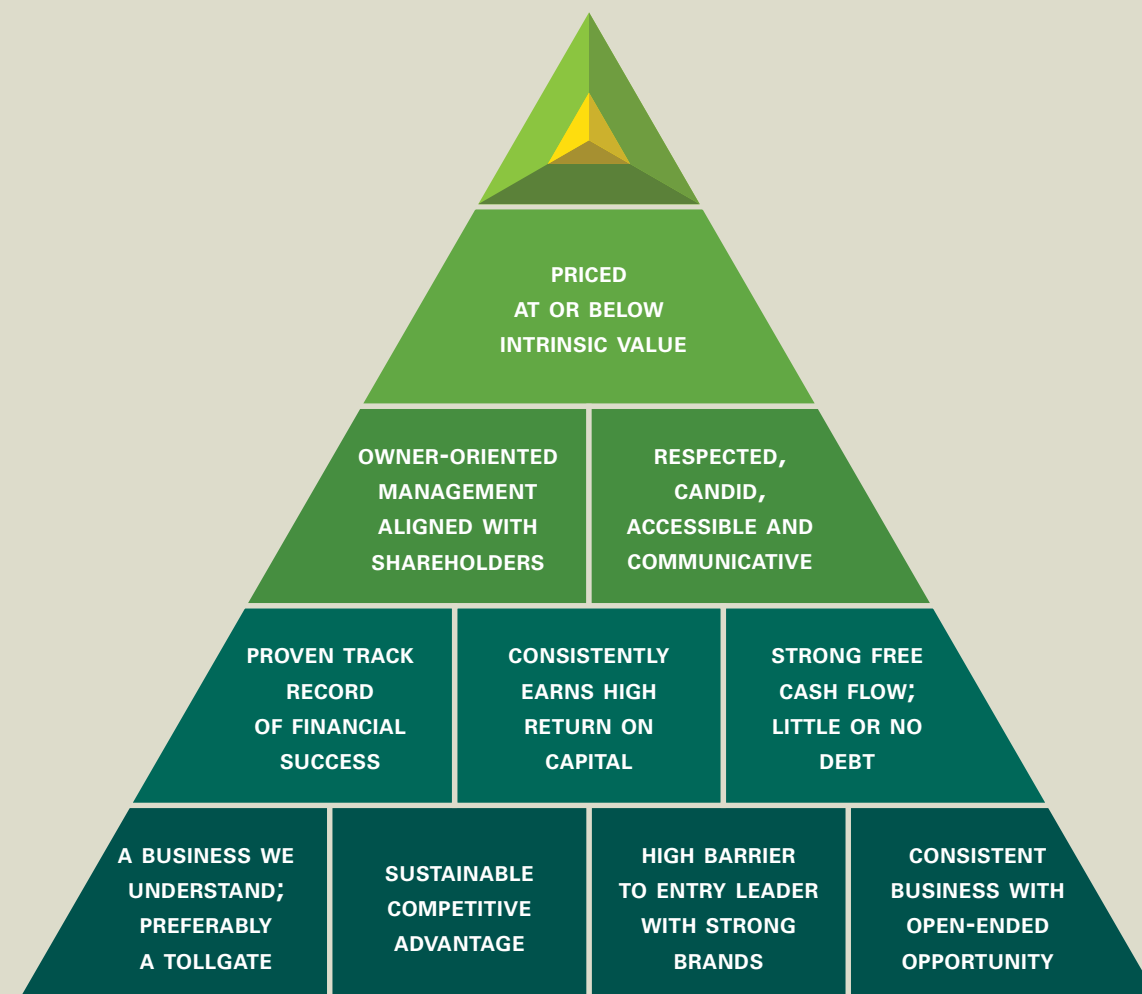
- **OPEN-ENDED OPPORTUNITY; EXPLOITS SECULAR TREND**

We are interested in companies that can benefit from an open-ended market opportunity with a tailwind of demand for a product that is needed or desired.

- **PROVEN TRACK RECORD OF SUCCESS**

We look for proven performers that have been tested by economic storms and competitive threats. An excellent track record is not a guarantee of future performance, but it is better than failed promises.

### INVESTMENT EXCELLENCE





- **CONSISTENTLY EARNS A HIGH RETURN ON INVESTED CAPITAL (ROIC)**

All else equal, the most valuable businesses are those that deliver more cash flow and income with fewer assets. A company that generates \$25 of cash income with \$100 of invested capital in the form of debt or equity is more valuable, all else equal, than another company that only generates \$10 of cash income with the same \$100 of invested capital. Generating a ROIC substantially greater than a company's cost of capital is a primary driver of creating shareholder value. A high ROIC is the best indicator of a company's productivity and evidence of a competitive advantage. A business gem that we prize is one that can sustainably generate a ROIC that is materially higher than its cost of capital.

- **STRONG FREE CASH FLOW; LITTLE TO NO DEBT**

Companies that generate free cash flow (cash flow from operations less capital spending) are self-funding businesses that are "masters" of their own financial destiny. As Warren Buffett says, they "don't rely on the kindness of strangers" for the lifeblood of their operations, especially when lending and stock financing frequently vanish in a tough economy.

*The Pyramid of Growth includes these criteria to determine management excellence:*

- **OWNER-ORIENTED MANAGEMENT ALIGNED WITH SHAREHOLDERS**

We are looking for management whose compensation and actions indicate that their interests are aligned with shareholders as equitable partners. We assess management to determine that they are trustworthy, passionate, focused and cost conscious. We like to see management repurchase stock opportunistically when the price is below intrinsic value. This benefits us as remaining shareholders since future earnings are spread over fewer shares which increases value per share.



- **RESPECTED, CANDID, ACCESSIBLE AND COMMUNICATIVE**

We seek management that is admired and respected for their integrity and accomplishments, especially by their peers. We want management to be candid and transparent in their communications with shareholders.

*Lastly, the Pyramid of Growth includes a test to determine whether the stock price is "on sale" compared to its value.*

- **PRICED AT OR BELOW INTRINSIC VALUE**

We look for opportunities to benefit from the inevitable decoupling between a business's intrinsic value and its market price. Intrinsic value is the present value of a business's future stream of cash flow discounted by the rate that reflects the risk of future uncertainties and investors' need to be compensated for postponing consumption. Intrinsic value for bonds is easy to calculate because the future cash flows are determined by the coupon rate. The challenge for equity investors is to estimate future "coupons" for stocks. The metrics we use to estimate intrinsic value may include discounted cash flow, free cash flow yield, enterprise value (debt and equity) to cash earnings, price earnings (P/E), P/E to ROIC, and price to book value for financial companies. In the long-run, intrinsic value tracks closely with the trends in cash flow generated by a business. In the short-run, market volatility, triggered by macro-worries or company specific issues that are temporary, fixable and non-structural, present opportunities to benefit from businesses "on sale."





# Why We Sell or Trim Stocks

*We buy stocks with the intent to hold them indefinitely. Change is constant however, and either differences in business fundamentals or market prices may warrant a portfolio change. There are five reasons why we would sell a stock.*

- **EGREGIOUSLY OVERVALUED**

We will sell a stock if the price is excessively overpriced relative to its intrinsic value. When a stock price is discounting earnings several years forward or if its valuation ratio is well above its historical range, we will sell. If a stock price is only modestly overvalued, for instance by 10-20%, we will hold the stock if we are confident it will grow into its valuation in the near future. Outstanding companies are not frequently on the bargain counter. Once we own one, we want to participate as fully as possible in their wealth creation. We are aware of many instances where an investor sells an exemplary company that is only modestly overvalued, fully expecting to buy it back cheaper, but the stock does not give the opportunity, and the cost to the investor of foregone profits is enormous.

- **BETTER IDEAS WITH MORE CONVICTION AND HIGHER UPSIDE RETURN**

We are constantly evaluating new investment players to become starters in our portfolio lineup. If a starter becomes permanently injured or is too pricey, we will make the substitution. Also, if a stock appreciates from a beginning mid-single digit percentage weight to a double-digit weight in the portfolio, we may trim the stock and reallocate the proceeds to more attractively priced investments.

- **DETERIORATING FUNDAMENTALS/ERODING COMPETITIVE ADVANTAGE**

Companies that enjoy high returns on capital and superior operating profit margins attract competition. If the barriers to competition erode and violate our original expectations for owning the company, we will sell.



- **KEY MANAGEMENT DEPARTURE**

Warren Buffett and Peter Lynch have said they try to buy stock in businesses that are so wonderful that an idiot can run them, because someday one will. The common reality is that management does matter. Companies once moribund have been resurrected to prosperity because of a change in leadership. Other companies have had wealth destruction due to weak, misguided or greedy management. When key management leaves a company, we will re-evaluate the new leadership to ensure we still like, trust and admire the new team, its incentive compensation structure, its communication and its strategy.

- **RECOGNIZING A MISTAKE**

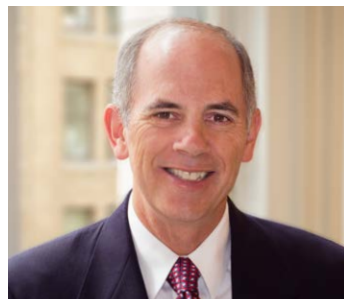
Despite our best effort to apply our due diligence process in assessing the sustainability of a company's competitive advantage, the competence of management, and our estimate of intrinsic value, we occasionally make mistakes. These are mistakes of commission, where we buy a stock that does not meet our expectations, and we sell to limit our losses. We also seek to minimize our mistakes of omission where we don't buy a stock that qualifies for purchase, which subsequently creates massive wealth. These don't appear on our report card, but they are costly nevertheless.





## Scott A. Chapman, CFA

CHIEF EXECUTIVE OFFICER AND PORTFOLIO MANAGER

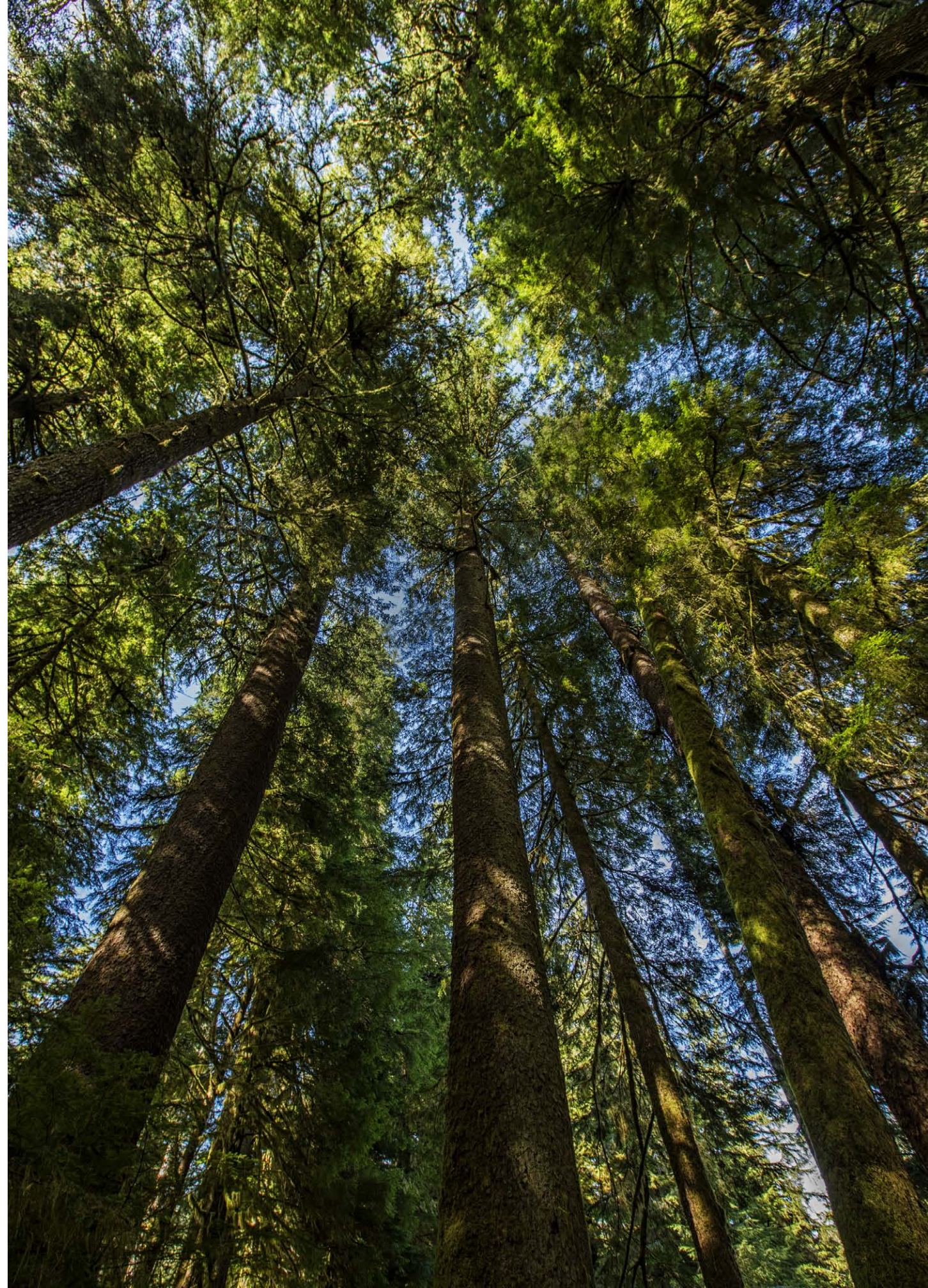


Scott A. Chapman is a Chartered Financial Analyst, CEO and Portfolio Manager of Chapman Investment Management, LLC, which he founded in 2013. He has more than twenty-five years of experience managing investment portfolios and performing securities analysis.

Mr. Chapman was Managing Director and Portfolio Manager with Lateef Investment Management from 2002-2012, during which time the firm's assets grew from \$500 million to over \$5.5 billion. At Lateef, Scott was a member of a three-person portfolio management team that delivered investment performance in excess of the S&P 500 by an average of 3.8% annually and outperformed the index in nine of eleven years, all with lower portfolio risk. The Lateef mutual fund earned the top five-star rating by Morningstar rating agency.

Previous positions included Senior Portfolio Manager, Director of Large-Cap Growth Strategy, and Research Director at Dreyfus Founders Asset Management, and Senior Portfolio Manager and Director of Growth Strategy at HighMark Capital Management. At HighMark, he designed and managed the investment strategy for the HighMark Growth Fund, which was also awarded a top five-star Morningstar performance rating.

He received his M.B.A. in Finance from Golden Gate University and his B.S. in Accounting from Santa Clara University. Scott taught investment principles to CFA candidates in San Francisco for seven years. He also developed and instructed investment seminars, called "Lessons from the Masters," which profiled the investment principles and case studies of stocks used by Sir John Templeton, Peter Lynch and Warren Buffett. He is currently writing a book on the subject. Scott is a national board member of Positive Coaching Alliance, former Chair of the Alumni Advisory Board for Golden Gate University's graduate school of business, and a volunteer treasurer and board member of a Hawaiian condominium association. He is married, has two grown children and enjoys running, cycling, swimming, reading and the fulfillment of making a positive difference in building client's capital.







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