Madison INVESTMENTS

U.S. EQUITY INVESTOR LETTER

December 31, 2022

To our investors and partners,

The U.S. stock market suffered one of the worst annual losses in its history, with the S&P 500, Russell Midcap, and Russell 2000 declining -18.11, -17.32%, and -20.44%, respectively. Headlines point to many culprits, but higher interest rates dominate the conversation. We've had four decades of declining interest rates; it's no coincidence that with rates rising sharply this past year, the S&P 500 Index had its third worst year in the past 40 years.

Few investors working today have experienced a prolonged period of rising rates. That includes myself and my colleagues, the oldest whose professional investment experience spans a little over three decades. So we don't have any firsthand war stories about the days of much higher rates. But Madison Investments was founded amid the inflation and rate turmoil of the 1970s, and our DNA is heavily infused with an attentiveness to risk. And while we view our long experience as an advantage, we take great care to think a lot about risks that we *haven't* experienced before or that seem farfetched. Thus, we have always incorporated the potential for higher rates as an input into our decision-making when investing. We've studiously avoided companies that rely on easy money to fund growth, maintain a lot of variable-rate debt, and have precariously leveraged balance sheets.

In our annual letter from two years ago, we wrote about the history of the property and casualty insurance industry and several of our investments in it. The letter noted how our investments had outperformed during our many years of ownership, but underperformed in that particular year under review. This past year, our insurers proved their worth once again. Their stocks performed strongly across the board, many up significantly, bucking the market downturn. Notable among them was Arch Capital, which ended the year as the largest investment in both strategies after some timely adds on our part and a 41.24% total shareholder return in 2022. The company continued to confirm our long-held assessment that it is the best-run large insurer in the world; seeds it planted years ago are flowering, and as industry opportunities shifted over the past few years, it has shifted its capital allocation too.

For many years, the property and casualty industry was in a "soft market" as underwriting standards steadily deteriorated along with declining prices. Arch's management team refused to loosen their standards, ceding market share in many lines rather than write business at unacceptably low returns. But they found ways to re-invest capital in a creative manner while sticking to its knitting. In 2017, the company acquired a large mortgage insurer for approximately book value. The mortgage industry and the accompanying mortgage insurance industry were still suffering from a generational hangover after the lending binge that led to the Great Financial Crisis. But by that point, the hangover was psychological only, driven by fear. Fear among capital owners, fear among capital distributors, and fear among regulators. Thus, eight years after the Crisis, capital remained scarce for mortgages and scarcer still for mortgage insurance, despite underwriting standards that were the tightest in decades. The result was that industry profitability was very high, even with risk very low. Arch took advantage by stepping in, buying the industry leader from a semi-distressed seller.

For several years after the acquisition, Arch enjoyed 15-20% returns on equity on its investment, with decent growth opportunities in a strong housing market. Starting a couple of years ago, growth opportunities in its mortgage unit slowed down while its stock price languished. Management turned to share repurchases as a leading use of its capital, buying back over 10% of its shares outstanding.

As its share price rose and conditions in the property and casualty Insurance and Reinsurance units began to improve, Arch began shifting its capital application to those segments. Last year, as returns on equity increased to 15% or more in those segments, Arch stepped on the growth pedal, increasing premium revenues by 27% in 2022. The company is in the enviable position of having plenty of capacity and excellent financial strength to take advantage of favorable industry conditions. Just like with mortgage insurance in the 2010s, many competitors in the property and casualty space today are dialing back, hesitant to commit capital as they deal with worsening losses from past policies and the fear of committing good capital after bad. This agile and constant redeployment of capital to its highest and best use is what makes Arch unique among large insurers. Even with the recent strength, its shares trade for approximately 12 times after-tax profits.

Another way our portfolios have benefitted from rising insurance prices is our investment in Marsh & McLennan and Brown & Brown, the world's largest and 6th largest insurance broker, respectively. Brokers act as middlemen in the insurance chain, helping businesses manage risk and buy the right policies, and earning fees and commissions for their service. Because they don't actually write insurance themselves, they have capital-light business models and high profit margins. Pretax margins for the insurance brokerage divisions at both Brown & Brown and Marsh & McLennan hover around 30%. And because most businesses are required to buy insurance to operate, demand for brokerage services is steady and recession-resistant. That proved to be the case in the pandemic-driven economic downturn in 2020, and it should be the case if an economic slowdown occurs in the coming year.

PRICING POWER

Rising inflation over the past couple of years has brought the topic of pricing power to the fore. As readers know, we are obsessive about investing only in companies with wide and deep moats. And one common feature of a moat is pricing power.

When costs are rising, a company has only two ways to protect its profits – find ways to be more efficient with expenses and capital outlays, or charge customers more. Typically, there's a limit to the former route. So, the ability to raise prices without adversely impacting demand is often a crucial characteristic of a good business. Many of our companies have demonstrated this attribute in this recent inflationary period. Some good examples are those with great brand strength (Brown-Forman, Nike), differentiated product performance (Arista Networks), or semi-exclusive distribution and high market share (Armstrong World, Copart).

To dig deeper into a specific example, Carlisle Companies, the premier commercial roofing manufacturer in the country, has been able to raise prices enough to more than offset cost inflation in raw materials and labor. In fact, it's been able to raise prices enough that operating margins in its roofing division increased sharply to over 30% recently after hovering around 20% when we first invested in the company's shares a few years ago.

The timing of our investment was no accident. While pricing power is important, we often find value specifically in *unrealized* pricing power, not realized pricing power. If a company already prices its products to the fullest extent possible, its profits already reflect this attribute, and investors incorporate it into their valuation; thus, there often is nowhere to go but down for profit margins and stock price.

If its value proposition to customers is strong enough and there are few viable alternatives for them to switch to, then it would be more than acceptable to invest in a company with fully realized prices. But all else equal, we prefer to invest in companies that haven't yet pulled the pricing lever. Why give your customers a reason to even think about an alternative? And why give competitors a potential opening to undercut you by a significant amount?

In Carlisle's case, the dynamics of the roofing industry had changed over the years, such that barriers to entry had risen and the number of competitors had dwindled. Not only that, changes in ownership of competing roofing manufacturers signaled more rational competitive behavior ahead. For over a decade, we had always thought that as the gold standard vendor with industry-leading service and products, Carlisle could raise prices more than it had. A new CEO took over several years ago, and after many conversations with him, we became convinced that he believed in this opportunity as well. The only question was executing on it. It took a few years to put the infrastructure, both technical and cultural, in place to follow through, but it happened. And the recent bout of inflationary pressure and strong demand gave it the necessary cover to execute on this promise. We think it's likely that when some of the inflation pressures reverse, Carlisle will have to give back some of the pricing. But price levels should remain well above where they were before, and the odds are good that profit margins will be permanently higher over the next decade than they were in the past decade.

In some cases, we would prefer that our investees *not* exercise the latent pricing power that they have at all. If a company can make its business more sustainable by charging lower prices than it could, we wholeheartedly agree with that strategy. Costco is an excellent example of this mentality embedded in its permanent business model.[1] Its management team is fanatical about giving its customers the best value it can find, never sacrificing that value proposition for short-term profits. And ten years is short-term for them. Their computer systems will not allow them to charge a price that's more than 15% above cost. We don't expect that Costco will ever raise its allowable margin. One reason is simply that retail is too competitive a business – the company may get away with it for a while, but eventually, its world-class franchise will erode, even if slowly. Investors may ask the question then: if two companies both earn 10% profit margins today, and one doesn't have the power to raise prices, while the other does but refuses to do so, should an investor value them differently? The answer is yes. The simple fact that a company has the ability to raise prices is a sign that its moat may be wider and deeper. And there is significant option value in the hypothetical but possible scenario that conditions may change in the future such that the company could raise prices without hurting its long-term prospects.

Sometimes, the thinking behind charging below-potential prices is to garner as large a customer base as possible, and then once customers get hooked on the product, raise prices. This works in certain situations, such as with software products that get so entrenched in a customer's workflow that it would be painful to switch to an alternative. This may be a rational, profit-maximizing strategy. In such cases, we don't worry too much about the low margin today (or sometimes, the lack of one!) and value the company assuming a much higher margin in the future. The valuation multiple on today's profits may look high at first glance, but when discounting for the higher margin in the future, it may be reasonable. We don't own any stock in companies that fit this description today, mostly for two reasons. One, the shares of these companies remain too expensive. And two, we think many of them will have trouble raising prices to the level anticipated. And we're not convinced that costs will come down as much as anticipated either.

[1] We don't own any Costco stock today but were previously shareholders for many years.

To be clear, a company doesn't have to have pricing power to have a moat. In fact, sometimes, the very notion of pricing power might be meaningless for a particular business model. We have an investment in Progressive Corporation, the second-largest U.S. provider of auto insurance. No company has pricing power in the auto insurance industry – it's a regulated, commodity-like product, and customers will tend to flock to the lowest price provider over time, given an acceptable level of service and financial strength. This is why the direct sellers of auto insurance, who don't have to pay commissions to agents, have been steadily gaining market share for years – they have a structural cost advantage. Progressive's goal is to attempt to charge less than the competition when risks are lower than the competition thinks and charge more than the competition when risks are higher than the competition thinks. They are extraordinarily good at that and thus have grown faster than their competition while maintaining much higher margins.

Although investors sometimes underestimate the value of pricing power, it's generally well-recognized and companies that have it tend to receive hefty multiples. This is where our concentrated approach makes sense. We don't need to find a lot of companies with this trait to impact your portfolio, just a small number. And importantly, our selective and independent-minded approach means we can identify and take advantage of situations where the market, in its search for proven pricing power, is underpricing latent pricing power (pun intended).

GROWTH AND VALUE

The massive outperformance of "value" stocks over "growth" stocks in 2022 has been a prominent topic of discussion for financial news outlets. The Russell 1000 Value Index declined -7.54% for the year, while the Russell 1000 Growth Index declined -29.14%. We pay attention to the Growth/Value distinction only in hindsight and only to explain performance to those that wish it discussed in those terms. From a research and investment decision standpoint, these labels make no sense to us, and we ignore them.

There is a scene in the classic 1980s movie *When Harry Met Sally*, where the lead character Harry tries to set up his best friend, Jess, with a female friend, Sally. Jess pesters Harry for details about Sally before going out on the date, and the following conversation takes place:

Jess: So you're saying she's not attractive?

Harry: No, I told you she IS attractive.

Jess: Yeah, but you also said she has a good personality.

Harry: She HAS a good personality.

Jess: When someone is not attractive, they're always described as having a good personality.

Harry: Look, if you were to ask me, "What does she look like," and I said "She has a good personality," that means she's not attractive. But just because I happen to mention that she has a good personality, she could be either.

We at Madison Investments often share in Harry's exasperation when attempting to explain our investment style with those steeped in the semantic mumbo-jumbo of the investment advisory industry. Growth versus value is a false dichotomy. We encourage investors to adhere to the plain English definition of those terms and not the industry lingo definitions. Value is what a company is worth, and growth is a characteristic of the company's outlook that serves as one of many inputs into its value. In fairness, it's true that some investors are more valuation-centric (i.e. willing to buy cheap stocks and not pay up for growth) while some are more outlook-centric (i.e. worry less about valuation and prefer to buy companies with strong growth prospects). We try to find an ideal balance between the two – neither overemphasizing value nor overemphasizing growth. Our pursuit of this balance has served us and our clients well, and we hope to keep it up in the future.

Respectfully,

Haruki Toyama

DISCLOSURES & DEFINITIONS

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Any performance data shown represents past performance. Past performance is no guarantee of future results.

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Equity risk is the risk that securities held by the fund will fluctuate in value due to general market or economic conditions, perceptions regarding the industries in which the issuers of securities held by the fund participate, and the particular circumstances and performance of particular companies whose securities the fund holds. In addition, while broad market measures of common stocks have historically generated higher average returns than fixed income securities, common stocks have also experienced significantly more volatility in those returns.

Diversification does not assure a profit or protect against loss in a declining market.

The S&P 500® is an unmanaged index of large companies and is widely regarded as a standard for measuring large-cap and mid-cap U.S. stock-market performance. Results assume the reinvestment of all capital gain and dividend distributions. An investment cannot be made directly into an index.

The Russell 1000® Value Index is designed to track those securities within the broader Russell 1000 Index that FTSE Russell has determined exhibit value characteristics.

The Russell 1000® Growth Index is designed to track those securities within the broader Russell 1000 Index that FTSE Russell has determined exhibit growth characteristics.

The Russell 1000® Value Index is designed to track those securities within the broader Russell 1000 Index that FTSE Russell has determined exhibit value characteristics.

The Russell Midcap® Index measures the performance of the mid-cap segment of the U.S. equity universe. The Russell Midcap® Index is a subset of the Russell 1000® Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership.

Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 11% of the total market capitalization of the Russell 3000® Index.

Madison Large Cap

9/30/2022 to 12/30/2022

Top Contributors to Return	Average Weight (%)	Contribution to Relative Return (%)
Arch Capital Group Ltd.	6.30	1.70
TJX Companies Inc	3.89	0.70
PACCAR Inc	4.18	0.43
Analog Devices, Inc.	4.19	0.40
Alcon AG	3.98	0.39

Bottom Contributors	Average Weight (%)	Contribution to Relative Return (%)
Alphabet Inc. Class C	6.35	-0.51
Brookfield Corporation	3.24	-0.47
Amazon.com, Inc.	3.82	-0.45
Black Knight, Inc.	1.96	-0.28
Dollar Tree, Inc.	5.06	-0.16

Madison Mid Cap

9/30/2022 to 12/30/2022

Top Contributors to Return	Average Weight (%)	Contribution to Relative Return (%)
Arch Capital Group Ltd.	8.52	2.14
Ross Stores, Inc.	5.88	1.47
Gartner, Inc.	6.46	0.71
Markel Corporation	2.78	0.31
PACCAR Inc	3.90	0.30

Bottom Contributors	Average Weight (%)	Contribution to Relative Return (%)
Carlisle Companies Incorporated	4.31	-1.20
Brown & Brown, Inc.	4.55	-0.71
CarMax, Inc.	2.76	-0.51
Brookfield Corporation	2.53	-0.41
Armstrong World Industries, Inc.	1.59	-0.39