Hutchinson
CAPITAL MANAGEMENT

April 2017

INVESTMENT PERSPECTIVES

Capital Allocation

Most of the time, capital is a scarce resource. At HCM, we're careful about how we allocate it when choosing investments, and in our research process we spend a great deal of time analyzing how others choose to invest theirs.

We use the word "Capital" throughout our writings, and it can mean different things depending on the context. When we discuss a company's capital, or the aggregate capital within an industry, we are referring to all the assets used in the business operations. It is also the total amount of debt and equity raised from investors, plus retained earnings since the company was formed. We will also sometimes refer to capital as the money that investors use to purchase stocks and bonds as part of the normal investment process. For instance, when we buy a stock for our investors, we are said to be "committing capital" to a particular investment. In the latter case, the company itself is not receiving the funds; our capital is going to the investors selling us the shares. This differs from instances when a company raises capital in an initial public offering or secondary share sale—in this case, investor capital is going to the company to become part of the capital used for their business operations.

The theme of our letter this quarter is capital allocation. We will share with you the two primary areas of interest to us when considering capital flows:

1. How much capital is flowing into and out of a particular industry and why; and
2. How a company's management chooses to allocate capital within its own business

While the first is a decision made by investors in aggregate, and the second is made by individual executives, in a fascinating way, these decisions are inextricably linked.

Capital Chases Returns

The term, "*Fair-Weather-Fan*" is used to describe that person whose favorite sports team is invariably the one currently doing best. If you're familiar with this, then you'll understand how capital flows into and out of different industries. Capital is a Fair-Weather-Fan; it flows into industries generating high returns (at the moment), and deserts those with returns below the cost of capital.

High returns are earned by companies with the pricing power to drive margins and profits. When demand for a company's products exceeds supply, pricing is strong and profits rise. This supply/demand imbalance attracts capital. This influx of funds finances capital expenditures, which increases product supply. These are normal fluctuations under the most basic laws of economics. The speed with which supply rises to meet demand depends on the complexity of the products and the power that the embedded competitors have to keep it out.

The second area of capital allocation concerns the company-specific decisions made by individual management teams. When a company has more cash flow than it requires to run its daily operations, it has three options: reinvest the money back into the business, pay down debt, or distribute it to shareholders in the form of dividends and share repurchases. As investors, we care very much about how management allocates their surplus capital. If a company generates high returns on capital and has ample growth opportunities, they should re-invest in their business. How this occurs depends on both the industry conditions and management's motivations. Since most investors favor companies showing the highest growth, executives with the opportunity to grow will usually do whatever it takes to keep those investors happy. But as we've mentioned in past Investment Perspectives, not all growth is good growth. There are numerous examples of industries that have experienced rapid growth, without benefitting investors.

One example of this is the gold mining industry. Mining companies make money by extracting gold and selling the commodity on various global markets. Profitability is simply the price of gold minus the cost of extracting the ore. So, all things being equal, a miner's profitability should be directly related to the price of gold; but all things are not equal. Between 2005-2015, aggregate debt of the gold-mining industry increased from $1 billion to $41 billion. This increase in debt was used to fund capital expenditures for mine expansion in the expectation of sustained high gold prices. From 2005 to 2011, the gold price per ounce rose from $430 to $1,420, averaging $803 over that six-year period. Managements, investors, and lenders were uniformly bullish as the gold price reached $1,900 in 2011. Equity investor enthusiasm enabled the industry to double share issuance over that period to fund mine expansion and corporate acquisitions. However, the incremental return on investment from equity and debt issuance was dreadful. Significant increases in capital couldn't drive enough production growth to generate the earnings needed to offset the dilution caused by the doubling of share issuance. Despite spending tens of billions of dollars on mine-capacity expansion--motivated by a tripling of gold prices, between 2011 and 2014--the aggregate profits of the gold mining companies fell from $14 billion to negative $5 billion. Gold production over that period rose by 13 percent, from 38 million oz. to 43 million oz.; BUT when that gold production is measured on an ounce per-share basis, the production **declined** from .38 oz. to .21 oz., down 45 percent. The gold price peaked at $1,900 in 2011, but just as all the new production was built out, the price fell steadily to sub-$1,100 levels, a decline of more than 40 percent. The decline severely undermined industry profitability, added further strain to balance sheets, and raised doubts as to future returns on capital committed to new mining projects.[1]

As a result of the carnage brought on by this boom-bust cycle, global mine production will likely decline by 25 percent through 2020. The debt and dilution was so destructive to the mining companies and their investors that, even a 50% rise in the price of gold will not likely bring new production. Smart management teams that were prudent and didn't get caught up in the mania of the 2005-2011 mining bubble, are now well positioned to make accretive acquisitions of those over-leveraged miners forced to sell quality assets at distressed prices. These well-managed companies will also be in a position to sell gold into a rising market for years. We haven't been interested in gold miners since the beginning of the bubble, but now that the capital cycle is turning, there might be opportunities that fit our process.

For investors in common stocks, when it comes to asset growth, less is more; there is a strong inverse relationship between asset growth and investment returns. Over the long run, companies growing their assets the most prudently are rewarded with the best stock performance. The chart below is a plot of the 1990-2015 stock returns broken out by deciles of asset growth. What it clearly shows is that the 10% of companies growing their assets the fastest, had stock returns of ~5% per year, while those 10% growing assets most slowly, returned ~12% per year. With this being so obvious, why are companies and investors so infatuated with growth? We're not 100% sure, but we suspect it might have to do with fact that most senior managers of U.S. corporations have a significant component of their compensation tied to some growth metric. We look for this when we analyze a company because we like management to make choices that align with shareholder interests rather than pursuing their own personal benefit.

[1] The Tocqueville Gold Fund Year End 2015 Investor Letter; John Hathaway

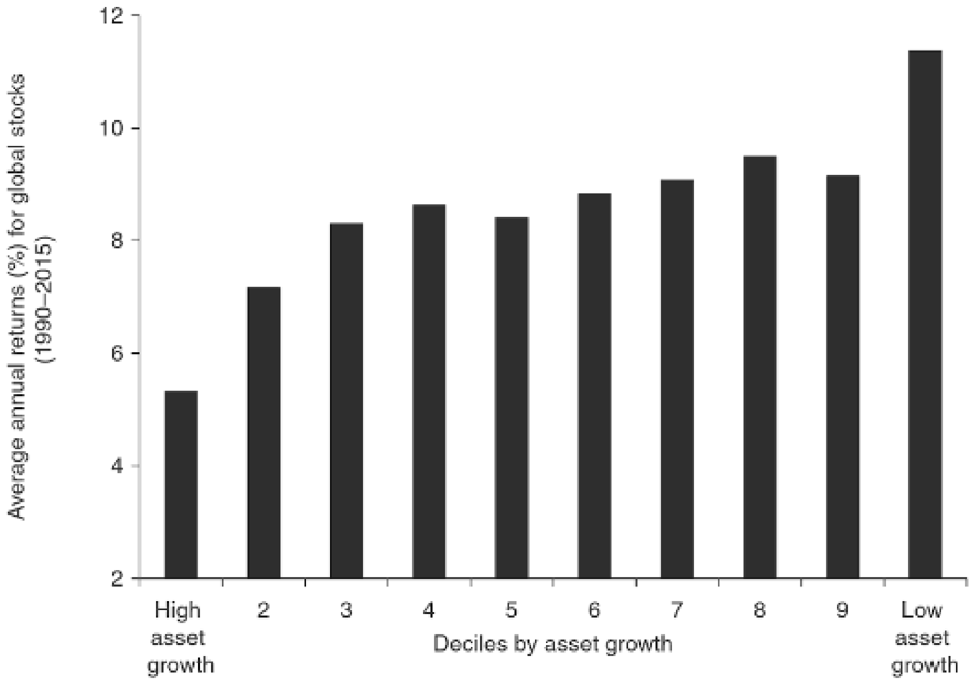

Chart I.2 Asset growth and investment returns

Source: SocGen.

The Curse of Success

There is a well-worn, if unscientific phenomenon known as the Fortune Magazine Cover Curse. It describes the odd frequency of misfortune that follows glowing cover-story articles. It's more than just bad luck. Behind it are behavioral biases that commonly upend investors and corporate executives alike.

Imagine you open your mailbox one morning to find a magazine cover sporting the smiling face of the CEO running your favorite company. The stock has been a great performer and it's your largest holding. On seeing the company featured so prominently in a major publication, you might think to yourself, "Aren't I clever. I bought this stock way before these professional journalists found it. All my friends own it and now everyone will know how great this stock is. It's going to the moon!" Only it doesn't go to the moon. Rather than serving as a catalyst driving the stock higher, the publication of the cover story on your company represents the sunset on its run of outperformance.

But how could this be? You read the article. The CEO said business was never better. Demand for their product is so high they can't meet it with current supply so they're expanding. He gushed about all the new state-of-the-art factories they're building. They can easily afford it because profits have never been higher. You agree with the CEO's self-assessment, he's a genius. His confidence pours from the pages. Even though it's already your largest holding, when you finish the article, your impulse is to buy even more stock. CEO's who believe their own media stories reinforce this mistake. This executive may be a smart and honest guy, but is he forward thinking enough to consider future supply? After all, he's not the only one to notice the high profits his company is earning. These excess profits draw competitors like bears to honey. Before long, other producers are entering their market, building capacity to meet all this current demand. In such races, the first to finish their new factories will be best positioned to capture these excess profits.

Like our fictional CEO, most investors can't see the supply through the demand, which is odd because supply is actually observable while demand is ephemeral. At HCM, we focus keenly on supply because product pricing and corporate profitability are driven more by the industry-wide supply of products than by the demand for them. Despite this, we believe that the investment industry spends 90% of its time analyzing demand and only 10% considering supply. We believe this is due to an infatuation with growth. Behavioral faults like herding and the comfort of groupthink make fertile ground for hype. Human beings love stories. Stories resonate with people regardless of their level of sophistication.

Nothing gets investors to overlook high valuations like stories of infinite demand. And because demand is unknowable, it's perfectly suited to storytelling. The future supply of products, on the other hand, is both visible and measureable. This is so because new product growth must be provisioned for with real money. Management must set aside the capital to pay for this future production. At HCM, we evaluate this on both the industry level as well as the company level. When analyzing a company, a key component of our assessment is management's skill at capital allocation; we glean this knowledge from both the historical track record of past investments, from our management interviews, and from industry contacts.

The Capital Cycle

All entry-level economics textbooks begin with simple charts showing nice, smooth supply-demand curves. These charts suggest that industry supply neatly rises and falls to meet demand. But in the real world, it doesn't work this way. Supply is usually "lumpy" and arrives late. In the case of our fantastic cover story company, the race to build capacity ends in a dead heat. Suddenly, all these new factories become operational and now there's more than enough supply to meet demand. You can probably guess what happens next; the price cutting begins. Lower prices mean lower margins for our fantastic company. Profits shrivel, taking the stock price along. How could it come to this when everything was so great? It's not a conspiracy against your favorite company; it's merely the natural, ebb and flow of the capital cycle.

At HCM, we watch these cycles because a core element of our investment process is to identify the best individual companies within industries transitioning from weakness to recovery. At cycle troughs, profitability is poor and capital flees toward greener pastures. As capacity is shuttered, competition diminishes, paving the way for renewed profitability. But these cycles take time, and to benefit from this approach requires a long investment horizon. We also must be able to withstand higher volatility, as companies and industries undergoing transition are typically more volatile than average.

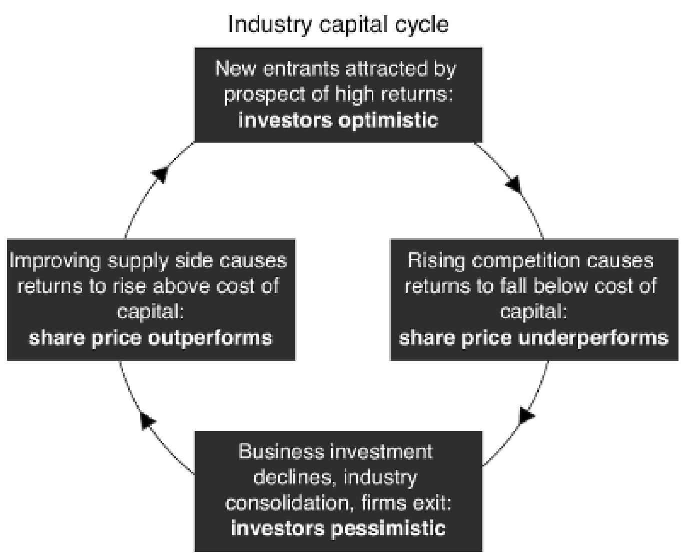

Chart I.1 The capital cycle

Source: Marathon.

Risk Management

Every investment boom and subsequent bust has resulted from misguided capital allocation decisions. Investors can get overly enthusiastic when confronted with a particularly compelling demand story. Such enthusiasm can overtake both investors and company management. They can see the company's assets growing rapidly to meet this unending demand. Because we pay close attention to capital flows, and avoid the most obvious targets of overzealous capital allocation, we have managed to sidestep much of the carnage of the last several investment busts. In talking about supply, we are referring not only to tangible, manufactured products like cars and computer chips, but also intangibles like car loans and drilling rights. When we evaluate a company, we ensure that the management team allocates capital wisely. This means avoiding the seduction of chasing growth, but also showing the courage to cut underperforming assets that are not earning their cost of capital.

We see as much value in management decisions to cut unprofitable assets as in decisions to undertake profitable growth. In fact, it's often much more difficult for companies to cull underperforming assets than to expand. Take as an example a company that decides to build an expensive, state-of-the-art factory. They commence building at the height of the cycle, but as we mentioned earlier, they must contend with the lag-effect. By the time the factory is operational, the competitive landscape may be vastly different. What should management do? What effect does this new plant have on industry-wide supply? Shuttering the plant means job losses, and large expenses; it is also an acknowledgment of failure. Therefore, most companies will opt to continue running the plant even if it's unprofitable to do so. This keeps unneeded supply in the marketplace longer than is economically sensible.

Asset Growth Anomaly

There are several explanations for the inverse relationship between asset growth and investment returns. When looking for new investment ideas, we are cognizant that corporate events associated with asset expansion (equity issuance, M&A, new borrowing, capacity expansion) tend to be followed by low returns, while efforts to contract (spin-offs, share buybacks, debt repayment, and dividend initiations) are followed by favorable returns[2].

- Over the long term, value stocks outperform growth stocks due to the asset growth anomaly
- When investors see abnormal growth, there's a human tendency to assume it's permanent; in reality, excessive growth slides toward average faster than investors expect
- Companies with high asset growth often have stocks with high price momentum; the capital markets are as fickle as our fair-weather sports fan

Contrarian but not Dogmatic

Being a contrarian thinker and using one's instincts is important, but it's not enough. Pure contrarian thinking in the absence of other considerations is simplistic. Just because investors seem overly enthusiastic about something doesn't mean they're wrong. If such an area of enthusiasm is not accompanied by vast capital flows, there's a chance the enthusiasm is not misplaced. Our investment process, while value-oriented, relies on more than just buying stocks at low valuation multiples. Our rigorous analytical work can put a seemingly high multiple into proper context. Only through a detailed assessment of the company's capital allocation policies can we estimate the magnitude, duration, and sustainability of returns underlying the valuation multiples.

Low valuation multiples do not assure an inexpensive valuation. During the run up to the peak of the housing market (2002-2007), the homebuilding stocks looked very cheap to many value investors. In late 2007, the homebuilders were the darlings of the value investing community. Investors focused exclusively on the demand for houses, saw it as nearly insatiable all over the world. And the companies building the homes to meet that demand were cheap--trading at only 1.0x book value. But investors who bought these stocks at 1.0x book value in late 2007 saw these investments down 75% even 4-5 years later. One notable stand out was PulteGroup (PHM). In November 2007, the stock was trading at $15/share with a price-to-book value of only 0.57x. In November 2011, PHM was trading at $3.75, down 75%. What many investors missed was the fact that these companies had been growing their capital bases by 25% per year for the five years leading to the peak of the bubble. In the case of PHM, they had grown their capital base from ~$2.0bil in 2002, to nearly $12bil by 2007, a stunning 43% per year!

Conclusion

Our focus on the capital cycle and capital allocation policy makes us different from the majority of our peers in the investment business. As we have discussed in many other Investment Perspectives and Position Papers, our investment process relies heavily on various measures of return on invested capital

[2] Journal of Finance (September 2014)

(ROIC)[3]. We were thrilled to write this piece covering capital allocation because it gave us a chance to shed light on critical elements of our valuation methodology. As so many investors focus primarily on earnings per share growth, we are always eager to take the opportunity to discuss how we do things differently. Since at least half of our analytical work revolves around understanding the capital side of the ROIC equation, we felt it would be beneficial to elaborate on some of the aspects that go into that effort.

- The capital cycle is akin to a pendulum swinging; it can reach extremes of boom and bust
- The investment environment over the past eight years has been complicated by financial market distortions; just as forests need occasional fires to cleanse the undergrowth, so too does the corporate landscape need recessions to clear the dead wood; easy money policies have prolonged this cleansing process
- Only when investment into an industry contracts, is the road paved for a recovery in profits; this is what we look for in new buy ideas
- Investors are infatuated with growth; this can lead to bubble-bust conditions and malinvestment
- When profits are high, confidence often accompanies it. This leads management to overinvest. It also attracts new competitors into the market
- Human beings are prone to extrapolating current trends; all things are cyclical, but stock prices nearly always reflect a linear forecast based on current conditions
- To deconstruct the capital cycle, investors must understand the industry's competitive framework
- It's essential to separate the genuine value of the company (the skill of management) from merely favorable industry conditions
- Companies experiencing high returns are often viewed favorably by analysts and the media. This can affect both management and the company's board. CEO compensation is often based on some component of growth; this may lead to unprofitable growth for the sake of growth rather than to enhance shareholder value
    - Capital expenditures directed at capacity expansion often result in short term share price appreciation—a response from growth/momentum investors[4]

[3] ROIC is the net operating profits (NOPAT) divided by total invested capital; it is essentially the amount of cash flow the business generates as a measure of how much total capital has been invested in the business
[4] Note: Much of the information, data, charts and inspiration for this paper was gleaned from the work of Edward Chancellor and the writings of managers at Marathon Asset Management, LLP. While our investment processes are similar, Mr. Chancellor is far more eloquent in his description. For any readers interested in learning more about these topics we highly recommend they read: ***Capital Returns***, Edward Chancellor; Palgrave Press, London, UK; 2016

PLEASE SEE IMPORTANT DISCLOSURES BELOW:

As of March 31, 2107, Hutchinson Capital Management (HCM) held:
0 shares of Pulte Group (PHM)

As of March 31, 2107:
PHM closed at $23.50

As of March 31, 2107, the following were the ten largest holdings of HCM:

Name of Issuer	% of Equity Portfolio	3/31/2017 Closing Price
ROBERT HALF INTERNATIONAL INC	6.20%	48.83
NATIONAL OIL WELL VARCO	6.05%	40.09
CARNIVAL CORPORATION	5.97%	58.91
WELLS FARGO & CO	5.67%	55.66
INTEL CORPORATION	5.36%	36.07
MOSAIC CO NEW COM	5.09%	29.18
WILLIAMS-SONOMA INC	5.05%	53.62
JACOBS ENGINEERING GR	4.76%	55.28
MERCK & CO. INC.	4.74%	63.54
NOVO-NORDISK A S ADR	4.70%	34.28

For a complete list of holdings, please see our most recent 13F filing on the following SEC website:
http://www.sec.gov/edgar/searchedgar/companysearch.html

HCM's investment decision making process involves a number of different factors, not just those discussed in this document. The views expressed in this material are subject to ongoing evaluation and could change at any time.

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