



October 2014

## INVESTMENT PERSPECTIVES

### New Era, Same Strategy

In past quarterly letters, we've detailed our investment process and outlined how we prefer to look at securities from an individual bottom-up basis rather than spend time obsessing about every macroeconomic headline that fills the airwaves. In our experience, focusing on the individual security level provides the best chance for investment success as the subset of investors who can consistently anticipate macro events and invest appropriately is incredibly small. But just because we don't obsess about macro headlines does not mean that we do not make contingency plans for certain events or make sure to take advantage of dislocations when they occur. While other macro events (wars, weather events, political elections) will be widely discussed over the coming months, we wanted to focus our discussion on how we are planning for the real possibility that interest rates could (finally) move higher in the coming months/years.

At the most basic level, higher interest rates are often negatively correlated with stock prices. At lower rates, all else equal - admittedly three of the most dangerous words in the English language from an investing point of view - stocks are generally viewed as more attractive given the limited return possibilities for safer assets. For example, energy behemoth Exxon Mobil's nearly 3% dividend yield compares more favorably with a money market account earning 0.1%. By contrast, at higher rates, stocks often look less attractive given the higher available returns on safer alternatives - using the same example, Exxon's 3% dividend yield may look far less interesting if we can earn 5% in a risk free money market fund. Interest rates have historically acted as a basic financial compass in valuing all sorts of financial assets - stocks, bonds, mortgages, car loans - as investors compare the necessary return required to hold riskier assets versus earning a so-called risk free rate of return from government bonds. This simplistic relationship between higher and lower interest rates and higher and lower financial asset valuation levels has served as a quasi-financial law of gravity.

And then the financial crisis of 2008-2009 hit and central banks all over the world began to transform previously theoretical discussions about how to take interest rates below zero into the real world policy of quantitative easing (QE)<sup>1</sup> - or debt monetization or money printing depending on your political or economic viewpoint. Clearly, the US economy was in crisis during 2008-2009 and

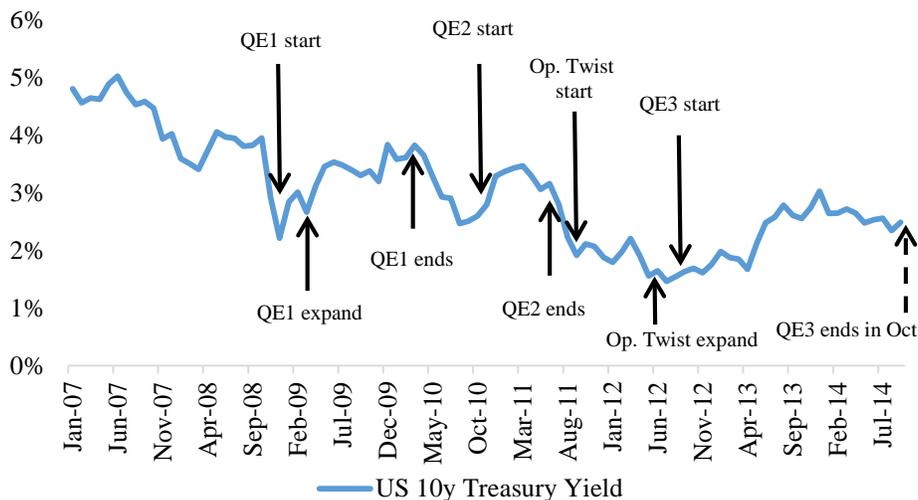
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<sup>1</sup> In quantitative easing, the US Federal Reserve or other central banks provide additional monetary stimulus by buying specified amounts of financial assets from commercial banks and other private institutions, thus expanding central banks' balance sheets. These actions raise the prices of purchased securities and lower their respective yields while simultaneously increasing the monetary base. Because central banks have the power to create new money, their theoretical buying power is limitless, albeit not without substantial consequences.

drastic actions were undertaken to prevent an even deeper downturn. A discussion of the effectiveness of these policies is beyond the scope of this letter. That said, we would simply make a couple of observations:

- Quantitative Easing<sup>1</sup> policies have likely kept longer-term interest rates lower than they otherwise would have been.

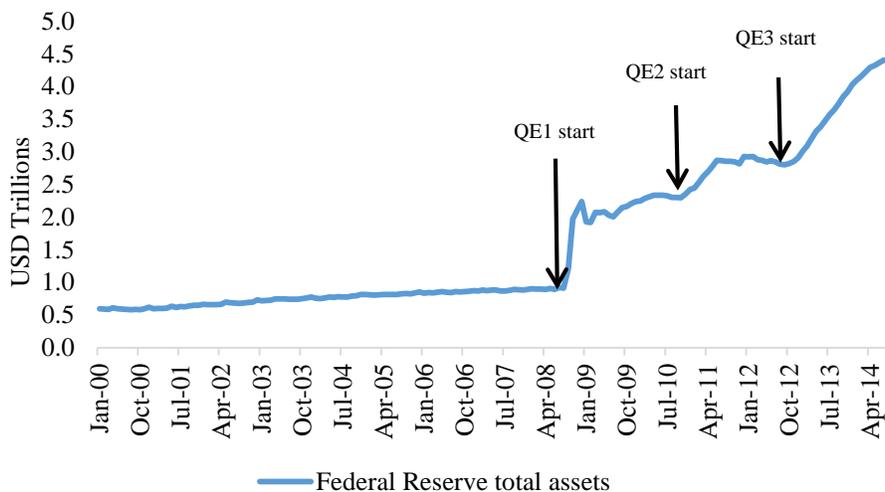
### QE<sup>1</sup>: Interest Rate Ceiling



Source: Bloomberg

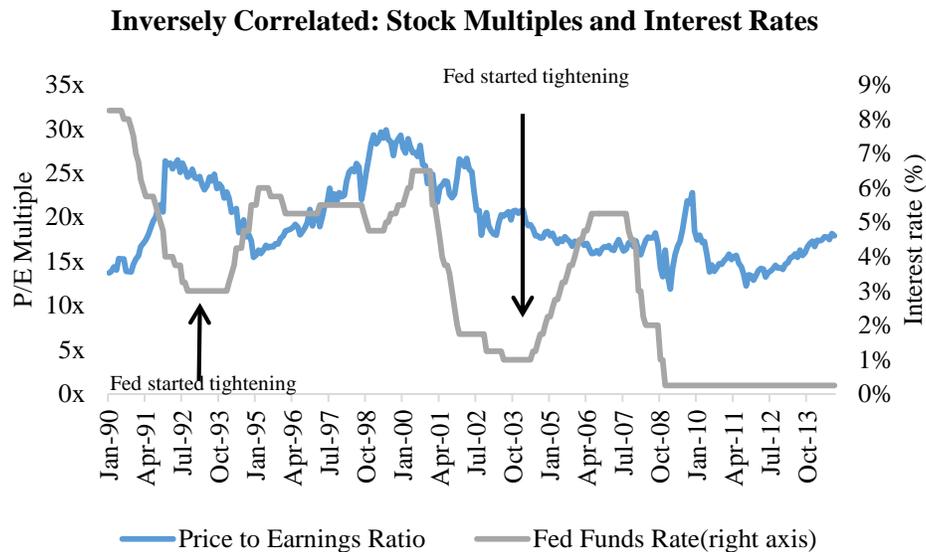
- The Federal Reserve has greatly expanded its Balance Sheet<sup>1</sup>.

### Balance Sheet<sup>1</sup> Expansion



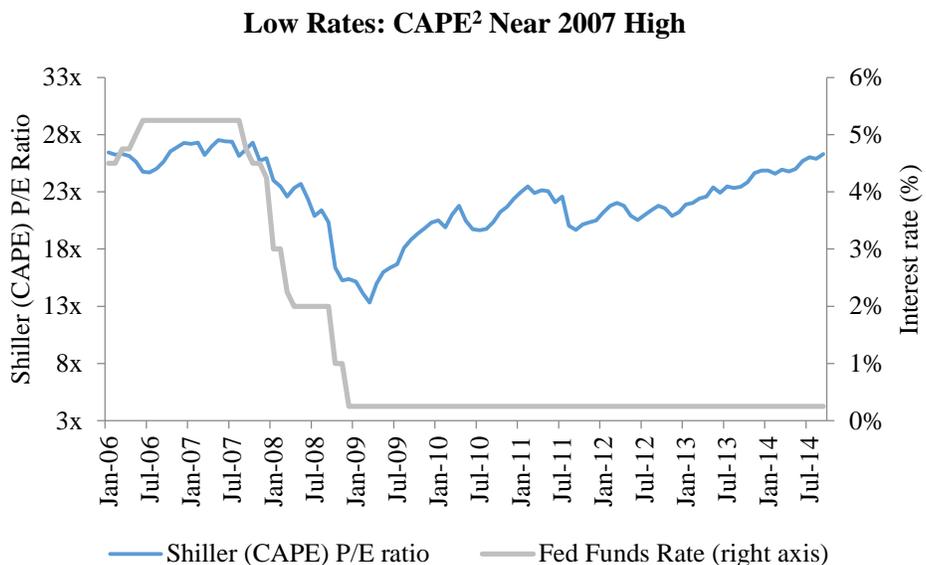
Source: Bloomberg

- Over longer periods of times, stock multiples (we show price to earnings below) to have generally increased during periods of falling interest rates and decreased during periods of rising rates.



Source: Bloomberg

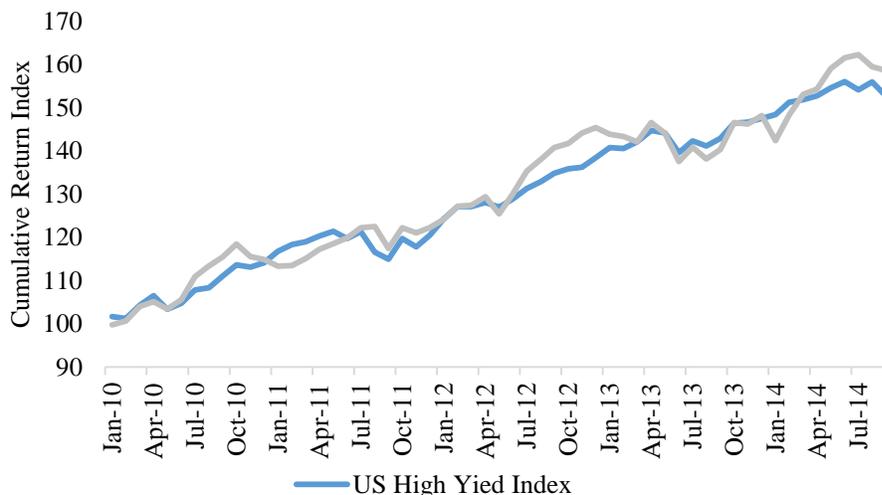
- Monetary actions have likely had some and perhaps significant impact on the prices of equities and high yielding assets...



Source: Yale University

<sup>2</sup> The cyclically adjusted price-to-earnings (CAPE) ratio, commonly known as CAPE, Shiller P/E, or P/E 10 ratio, is a valuation measure usually applied to the US S&P 500 equity market. It is defined as price divided by the moving average of ten years of earnings, adjusted for inflation.

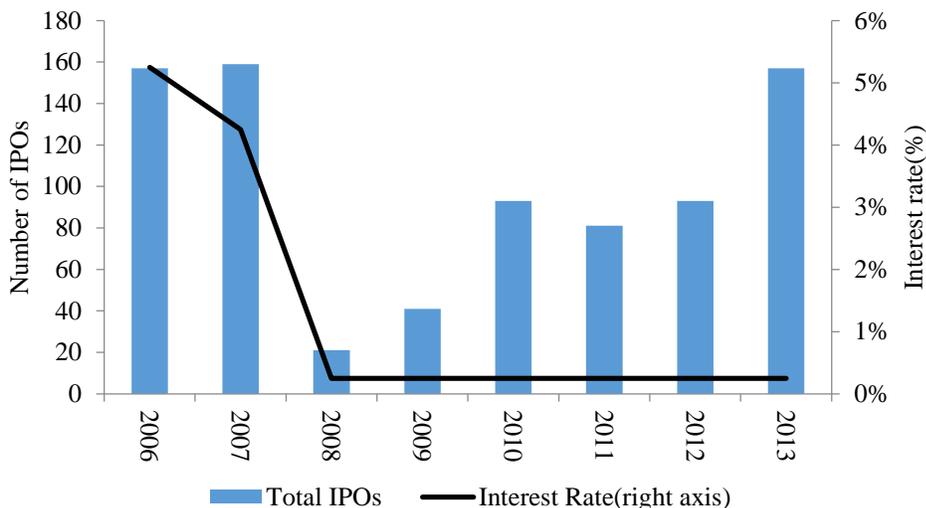
### Low Rates: High Yield Extravaganza



Source: Bloomberg

- ...and certainly driven growth starved investors into faster growing but amazingly expensive young, technology companies.

### Low Rates: High-Priced IPOs



Source: University of Florida

We would venture that millions of trees have been killed by investor advisors writing about the possibility of higher rates over the past several years and we realize that one additional letter very well may feel like a reading of *Waiting for Godot*. That said, recent events suggest the unwinding of interest rates has probably begun. In December of last year the Federal Reserve announced it was scaling back its bond buying program. In June of this year, the Federal Reserve announced it was ending its program by October of this year and, at its last meeting on September 17th 2014, the Fed

forecasted short-term rates to rise to 1.25% by 2015. Recent US economic and job data has further increased expectations of future rate increases.

And while a strengthening US economy is allowing the removal of the above monetary stimulus, other major economies (Eurozone and Japan in particular) continue to face lackluster growth. For this reason, the European Central Bank and Bank of Japan very well could choose to continue or to expand monetary stimulus at the same time the US Federal Reserve is withdrawing the medicine. These contrasting actions are likely to exacerbate movements in exchange rate as well as government bond and global equity prices. To be clear, while we do believe that rates will likely rise and the increase could be faster than anticipated, we think discussions of a new Weimar Republic are more than a bit extreme. For starters, while we anticipate higher rates in the coming months/years, the increase will not be linear. In fact, the US ten year bond yield has actually declined roughly 55 basis points since the start of the year. Additionally European monetary actions could actually make low-yielding US government debt more attractive shorter-term relative to European bonds. If ten year Italian bonds (backed by a heavily indebted government with lackluster growth prospects) trade at comparable yields to their US counterpart, which security would you want to own? Despite these shorter-term headwinds that may temporarily cap rates, we think longer-term increases remain inevitable.

So what does all of this mean for investors? In short, we simply don't know. There are too many variables for anyone to predict immediate effects, not to mention the multiple knock-off events that will unfold in the coming years. Investors always face uncertainty when making decisions, but the unprecedented central banks' action has pushed us into somewhat uncharted territory when thinking about normalized interest rates and risk premiums. We do believe that there will likely be increased volatility in all financial assets. While this volatility may prove unsettling at times, we have strived to position portfolios to be prepared for this and to ultimately take advantage of it to protect and grow assets. Before we describe our thinking in more detail, we suggest that readers should temper their expectations for future returns. The S&P 500 compounded at 14.5% annually from 2009-09/30/14. While equities may continue to perform reasonably well, we think returns of this magnitude are unlikely given current valuation levels and the prospect of higher interest rates. We think expansionary monetary policy has likely provided some benefit for equity valuations, but the exact degree of support will likely not be known for years to come.

On the fixed income side, we exclusively invest in a portfolio of highly rated bonds and have generally kept durations short. As the bonds more frequently mature, we hope to invest principal balances in higher yielding securities. While the low fixed income yields have been frustrating to endure over the past several years, this piece of the portfolio will continue to serve as a shock absorber for the portfolio. As we generally hold bonds until maturity, we ignore shorter-term fluctuations in prices, especially given the aforementioned shorter durations. Higher rates will allow higher levels of coupons, create more attractive opportunities and we welcome these increases.

Certainly, the stock portion of the portfolios will likely experience increased volatility and some of this volatility may have already started as we write this letter. Investors who piled into higher yielding securities scrounging for yield may be very quick to sell utilities, master limited partnerships, real-estate investment trusts among other assets. As we outlined in our Q4 2013 letter

and illustrated above, many technology names have soared to nearly incomprehensible valuations, at least partially in response to a lower interest rate environment that has pushed capital into faster-growing names regardless of valuation support. The prospect of higher rates has caused the US dollar to rally nearly 8% against a basket of other developed market currencies in the past 3-months, and a continued dollar rally could pressure the reported results of foreign holdings and the US dollar denominated results of US multinationals. A stronger dollar combined with weaker worldwide economic growth could also cause further weakness in oil prices and cause broad based selling in the energy sector.

A large majority of the names in the above industries or asset classes are either fairly priced or overvalued from our perspective, and therefore we will have little interest in owning them despite lower prices. But as we only own a smaller number of businesses, indiscriminate, sector-wide selling can often allow us opportunities to grab the proverbial baby tossed aside with the bathwater. Over the coming months, we think we'll have opportunities to add to positions in a few of our existing holdings that have or soon may be caught up in the above pressures, including Redwood Trust, Arcos Dorados, and Liberty Interactive among other names. While higher rates may also cause some short-term pressure in Leucadia's share price, our recent conversations with the company's CEO further increased our confidence in the attractiveness of their businesses at current prices. Continued selling in energy related names could also provide opportunities in National Oilwell Varco and its spinout, Now Inc.

Furthermore, increased volatility should allow us to purchase additional new names that we have been researching over the past months. As we noted in our 2014 Q1 letter, we try to build a robust list of on-deck names that we would like to purchase at lower prices, and we are in more advanced stages on a couple of names. Not every name will become a new holding but a market slide could push a couple past the finish line. Depending on the portfolio, we may have to incur taxes as we allocate capital towards the names we view as having the most attractive risk/reward characteristics. We do not take this decision lightly and will weigh all new investments versus the taxes that must be paid upon exiting existing names. Additionally, we will make every effort to minimize taxes and to use losses to offset gains whenever practical. We will not time these new purchases perfectly as some could quickly drop below our initial purchase price while others could languish for longer periods of time.

But successful investing is a marathon, not a sprint. We judge our companies on their ability to create longer-term value for shareholders and often the best time to purchase occurs during some period of uncertainty. We cannot promise that all investment decisions will immediately benefit shorter-term performance or that all of these investments will ultimately prove successful. We can promise, however, that every new purchase or sale will involve a rigorous quantitative and qualitative analysis of the potential upside/downside for each investment before any decision is finalized. Additionally, we will continuously question ourselves and assess if our original analysis was misguided or if capital can be better employed in alternative ideas. We can also assure all clients that we will personally own securities purchased and align our personal financial interests with those who entrust us with their capital.

In concluding, we would reiterate that the United States is likely exiting an unprecedented era of lower interest rates and Federal Reserve bond buying. This new period will not exactly match the journey of other global economies and this mismatch combined with relatively full valuation levels could likely increase volatility in the months ahead. While we cannot foresee every possible permutation stemming from higher rates, we can work to ensure that our clients hold an appropriate mix of stocks, bonds and cash, that bond holdings act as shock absorbers for the portfolio and are positioned to take advantage of higher rates, that our stock ideas are thoroughly researched and personally owned to align our interest with our clients. Finally, we will continue to focus on investing performance over longer periods of time, understanding that a more cautious stance may negatively impact shorter-term returns. As the saying goes, it is difficult to make predictions...especially about the future. But we do believe our disciplined investing approach has stood the test of time and can successfully navigate client portfolios in the years to come regardless of what the future brings.

We thank you for your continued support.

PLEASE SEE IMPORTANT DISCLOSURES BELOW:

As of September 30, 2014, Hutchinson Capital Management (HCM) held:

58,166 shares of Exxon Mobil Corporation (XOM)  
494,443 shares of Redwood Trust Incorporated (RWT)  
1,363,370 shares of Arcos Dorados Holdings (ARCO)  
380,234 shares of Liberty Interactive Corporation (LINTA)  
694,349 shares of Leucadia National Corporation (LUK)  
112,207 shares of National Oilwell Varco (NOV)  
247,579 shares of Now, Inc. (DNOW)

As of September, 30 2014:

Exxon Mobil Corporation (XOM) closed at \$94.05  
Redwood Trust Incorporated (RWT) closed at \$16.58  
Arcos Dorados Holdings (ARCO) closed at \$5.98  
Liberty Interactive Corporation (LINTA) closed at \$28.52  
Leucadia National Corporation (LUK) closed at \$23.84  
National Oilwell Varco (NOV) closed at \$76.10  
Now, Inc. (DNOW) closed at \$30.41

As of September 30, 2014, the following were the ten largest holdings of HCM:

Name of Issuer	% of Equity Portfolio	9/30/2014 Closing Price
MICROSOFT CORPORATION	7.3%	46.36
JOHNSON CONTROLS INC	6.3%	44.00
WELLS FARGO & CO	6.2%	51.87
CVS CAREMARK CORPORATION	6.0%	79.59
MARKEL CORP COM	5.8%	636.15
GENERAL MOTORS CORP.	5.3%	31.94
LEUCADIA NATIONAL COR	4.9%	23.84
CARNIVAL CORPORATION	4.0%	40.17
MERCK & CO. INC.	4.0%	59.28
INTEL CORPORATION	3.7%	34.82

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.

Past performance is not indicative of future results, which may vary. The value of investments and the income derived from investments can go down as well as up. It shall not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities mentioned here. While HCM seeks to design a portfolio which reflects appropriate risk and return features, portfolio characteristics may deviate from those of the benchmark.

Although HCM follows the same investment strategy for each advisory client with similar investment objectives and financial condition, differences in client holdings are dictated by variations in clients' investment guidelines and risk tolerances. HCM may continue to hold a certain security in one client account while selling it for another client account when client guidelines or risk tolerances mandate a sale for a particular client. In some cases, consistent with client objectives and risk, HCM may purchase a security for one client while selling it for another. Consistent with specific client objectives and risk tolerance, clients' trades may be executed at different times and at different prices. Each of these factors influence the overall performance of the investment strategies followed by the Firm.

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