HUTCHINSON
CAPITAL
MANAGEMENT

April 2014

INVESTMENT PERSPECTIVES

Partnering to Achieve Long-Term Outperformance

Following some initial volatility, equity markets have continued to move higher during the first part of 2014. In an ideal world, stocks that you wanted to purchase would move sharply lower at the exact time you were ready to buy while those you have already purchased would continue moving higher. In reality, this scenario rarely materializes for money managers as there will often be periods when most names move higher or lower together. For the better part of the past two years, we've experienced a rapidly steepening market advance, with the vast majority of names broadly moving higher. The upward bias in all markets has made it more difficult to immediately invest money into new and existing names as stock prices have sometimes moved a bit faster than companies' corresponding changes in value. We, however, continue to believe that periodic market corrections will allow HCM to purchase new and existing names in the months ahead. Certainly, it is possible that our patience may not be immediately rewarded and rapidly rising markets combined with elevated cash positions could lead to periods of underperformance. As we will elaborate further, however, we strive for longer-term outperformance, avoid obsessing over a single year's performance, and continue partnering with clients who understand our methodology.

In thinking about how HCM will invest client funds over the coming months and years, we would encourage readers to remember that a lack of trading activity does not equal a lack of work. In fact, we think investors often get into trouble thinking they need "to do something" and therefore make snap decisions with regard to their investments. As markets have been rising for the past couple of years, some investors likely want their managers to hit the "Buy" button and immediately fully invest capital to avoid missing advances. The same investors might have been quicker to hit the corresponding "Sell" button during 2008-2009, thinking again that managers must react to negative macroeconomic news and protect portfolios. For some investors, increased activity signals increased progress. Following this same logic, investors often switch managers after a short period of underperformance or increase investments with those who have outperformed over a shorter time period. This mentality is likely a primary driver of why a 2013 Morningstar study found that the average investor often does even worse than published fund returns[1]. As seen from the below chart, after taking into account the inflows and outflows of customer funds (dollar weighted returns), the average investor fairs poorly with a more market timing mentality– nearly 1% lower annually over the 10 years ended December 31, 2012. This return drag from attempted market timing has serious financial consequences over time. Consider that $1 million invested would be worth nearly $169,000 less after 10 years if one achieves the lower dollar weighted returns of all funds versus published returns. If the same drag were to continue over 20 years, the difference would be nearly $638,000.

Asset-Weighted and Average Total and Investor Returns--Trailing Through Dec. 31, 2012

Category	Avg. 3-Yr Total Return	Ast-Wgt 3-Yr Investor Return	Avg. Fund Vs. Avg. Investor	Avg. 5-Yr Total Return	Ast-Wgt 5-Yr Investor Return	Avg. Fund Vs. Avg. Investor	Avg. 10-Yr Total Return	Ast-Wgt 10-Yr Investor Return	Avg. Fund Vs. Avg. Investor
US Stock	10.04	9.80	0.24	1.55	0.75	0.80	7.89	6.88	1.01
Sector Stock	9.28	8.26	1.02	1.54	1.07	0.47	9.44	9.07	0.37
Intl Equity	5.18	5.10	0.08	-2.43	-3.01	0.58	9.95	6.84	3.11
Balanced	7.49	7.72	-0.23	2.08	2.49	-0.41	6.37	5.53	0.84
Taxable Bond	6.94	5.75	1.19	5.80	5.16	0.64	5.63	4.76	0.87
Muni Bond	5.91	4.49	1.42	4.71	3.33	1.38	4.06	2.71	1.35
All Funds	7.59	7.36	0.23	2.02	1.49	0.53	7.05	6.10	0.95

Source:Morningstar Direct.

As you can imagine, we take a different approach. Many times, large amounts of the research performed at HCM may never actually translate into specific buy or sell decisions but this hardly signals wasted efforts. Investing knowledge is truly cumulative, and insights gathered from one prospective investment assist us as we make other purchases or sales. We believe the odds of investing success increase with the more companies examined – the one who turns over the most rocks stands a better chance of winning. Often, large amounts of the research process are done far before we actually make any investment decision - in this manner, we normally view ourselves as the diligent student always preparing for the surprise exam as opposed to the one trying to pull everything together the night before the test. We spoke with and modeled multiple different technology companies before deciding to purchase Intel shares last fall. The information gained from these conversations, combined with the insights from purchasing Microsoft earlier in 2013, helped us gain conviction in our Intel decision, even though our initial conversations were targeting a different company. In a similar manner, we think understanding the nuances of a John Malone controlled entity (Liberty Interactive) will make it far easier for HCM to purchase other parts of his ever changing media empire in the months ahead.

[1] The average return represents Morningstar's estimate of the returns typically received by a fund holder based upon the weighted average money flows of the fund versus the fund's actual net asset value return. Across almost every category and every timeframe, the average investor return lags the fund's return. So for example, across all funds, the asset-weighted 10 year return for all funds was 6.1% vs. the actual 10 year fund returns of 7.05%, meaning the average investor did 0.95% worse the funds' published returns.

Sometimes, we will spend minimal time on a name and pass because of immediate reservations about growth opportunities, concerns about management or valuation levels. Other times, we will spend days or weeks on a single name and then ultimately pass altogether or decide to only purchase at a lower entry point. In both cases, we still believe that our efforts will ultimately assist us with a decision on an existing name or lead to a new opportunity at a later date. As we previously stated, markets have moved higher and it is more difficult to find new investment ideas. But we continue to build an attractive "On Deck" list of names, and this current work will make it far easier to quickly deploy capital as corrections occur. While this effort may not be visible to clients, we believe it is an essential part of our strategy of owning a select group of businesses for longer periods of time.

At HCM, our goal remains to outperform the market over a complete economic cycle. Paradoxically, the best way to achieve this goal is to avoid thinking about performance in any individual calendar year. We do not purchase more financial names because we think this sector will do better in 2014 nor do we sell consumer discretionary names because we believe this will help us outperform during the year. We have a view about where individual businesses will trend over the next 3-5 years, but we have no special insight as to where their stock price will finish in any particular calendar year. We have discussed our rational for owning shares in Markel in past letters and noted that we think book value per share can continue compounding at a low-to-mid double digit rate per year over the next 5-10 years (Markel actually grew book value at 17% compounded annual rate over the past five years). Given this belief, why should we pay close attention to where the stock has traded year-to-date and worry whether it has under or outperformed the broader index during 2014? In fact, we take steps to avoid thinking about shorter-term performance. There are no CNBC television screens at HCM, and our offices more closely resemble a library than a trading floor. We view both as meaningful competitive advantages.

Again, HCM's goal remains longer-term outperformance. As such, we will continue to hold cash when we cannot find new investment ideas, and this could hurt our short-term numbers, especially if markets quickly move meaningfully higher (a so-called "melt-up" scenario). Some pockets of the market outlined in last quarter's letter continue to trade at nosebleed valuation levels, but expensive stocks could become even more overpriced and perhaps propel the entire market materially higher. We just have no way of predicting market movements so we spend little time obsessing over broader predictions but instead try to prepare ourselves for whatever ultimately materializes. In some ways, we view our efforts as not that dissimilar to a vacationer who simply chooses to bring both sunscreen and an umbrella in preparation for a planned weekend at the beach one month from now rather than someone who obsessively tries to read satellite photos, study almanacs, or chart star alignments to gain insight into predicting weather patterns that are inherently unpredictable. We do believe, however, that our extensive work on new and existing holdings will ultimately provide plenty of opportunities to intelligently invest capital and to continue generating strong long-term performance for our client base.

Of course, our investment discipline is not the only ingredient necessary for investment success. We also need partners who understand and believe in our process. Markets go up and down and the natural human emotions of feed and greed often impede the investment decision process as evidenced by the previously mentioned Morningstar study. Just as turbulence on airline flight is generally uncomfortable for all passengers, we understand that pockets of volatility and underperformance are less settling. We strive, however, to have an open dialogue with clients, to articulate our investment rational for individual purchases and sales, and to emphasize that we personally invest in the exact same names as clients, meaningfully aligning HCM with our clients. We fully acknowledge that mistakes will be made, but we attempt to learn from these and apply them in future investment decisions. Clearly, we try to select clients who identify with this philosophy, but we have had failures in this area as well. During 1999-2000, a meaningful percentage of HCM's asset base decided to switch to managers who freely pursued ridiculously overvalued technology companies. We refused to play this game and when push came to shove, proved that HCM would rather lose clients than lose money for clients. We cannot promise outperformance in any calendar year, and we will generally avoid working with clients who exclusively focus on shorter-term results. But our investment approach has stood multiple tests over the past decades, and we believe it has rewarded our longer-term clients and will continue to do so for years to come. We thank all clients for their continued support.

PLEASE SEE IMPORTANT DISCLOSURES BELOW:

As of March 31, 2014, Hutchinson Capital Management (HCM) held:
368,727 shares of Intel (INTC)
548,236 shares of Microsoft (MSFT)
381,019 shares of Liberty Interactive (LINTA)
31,093 shares of Markel (MKL)

As of March 31, 2014:
Intel closed at $25.81
Microsoft closed at $40.99
Liberty Interactive closed at $28.87
Markel closed at $596.10

As of March 31, 2014, the following were the ten largest holdings of HCM:

Name of Issuer	% of Equity Portfolio	3/31/2014 Closing Price
JOHNSON CONTROLS INC	6.9%	47.32
MICROSOFT CORPORATION	6.6%	40.99
WELLS FARGO & CO	6.2%	49.74
CVS CAREMARK	6.0%	74.86
GENERAL MOTORS CORP.	5.8%	34.42
MARKEL CORP COM	5.5%	596.10
BANK OF NEW YORK CO	5.4%	35.29
LEUCADIA NATIONAL	5.4%	28.00
EMERSON ELECTRIC CO	4.6%	66.80
MERCK & CO. INC.	4.0%	56.77

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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