HUTCHINSON
CAPITAL
MANAGEMENT

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INVESTMENT PERSPECTIVES

Succeeding Unconventionally

"Worldly wisdom teaches that it is far better for reputation to fail conventionally than to succeed unconventionally." John Maynard Keynes

Our goal in this Investment Perspectives is to provide some clarity behind the recent volatility in the stock and bond markets and what it might mean for your investments. Much attention is paid to this by the media because, for many investors, price volatility is the same thing as risk. However, we think about risk not as the temporary ups and downs of stock prices over days or weeks, but rather as the permanent loss of value that comes from paying the wrong price. Our process for managing your funds is research-intensive and thoughtful, never reactive or conventional; in our opinion, this is the best investment approach under all market conditions.

Mr. Keynes was referring to the tendency of investors and scholars to always do what is conventional, therefore avoiding risk to one's career and intellectual reputation by being singled out should failure strike. We sympathize with such fears, and while the appeal of safety in numbers may work well for wildebeest, herd behavior usually proves disastrous in the investment world. Every year approximately 1.5 million wildebeest embark on a year-long, 1,200 mile circular journey across Tanzania's Serengeti National Park in what is called the Great Migration. Interestingly, most of this massive group ultimately ends up in the same place despite the absence of an intelligent leader. If we could single out any individual herd-member and ask him where he's going, the answer would undoubtedly be, "wherever the guy in front of me is going." This long trek is fraught with danger from predators and accidents, resulting in the demise of more than 20% of the total herd. To improve the odds of survival, the safest place to be is tucked into middle of the pack, following the tail in front of you.

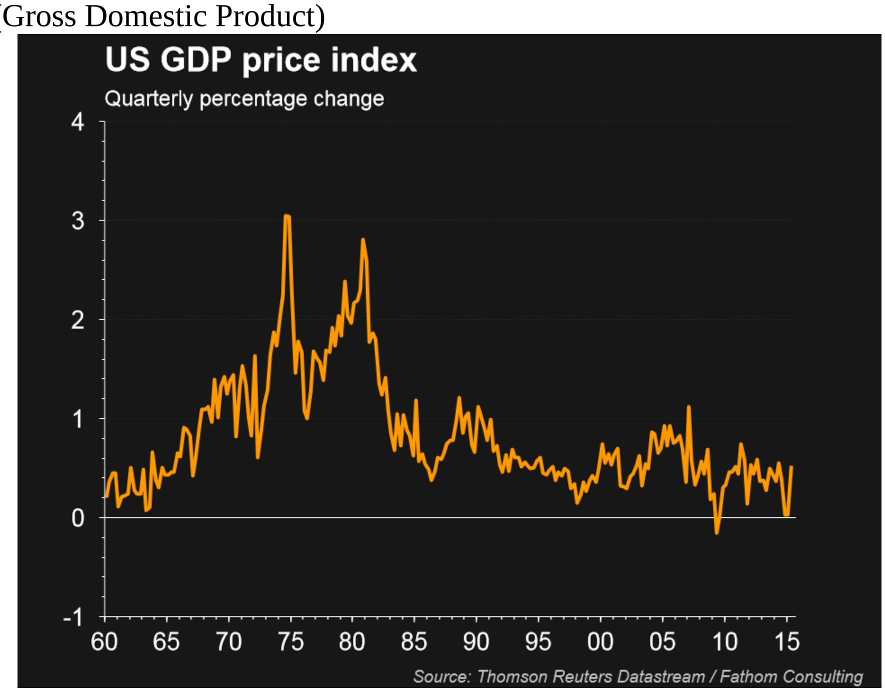
Trend is a Fickle Friend

Investors have their own versions of herd behavior. One of the most prominent is an investment strategy called: *Trend Following*. It's dependent upon the popularity of a given trend attracting increasing numbers of investors in order to grow the herd around them and thus fortify their position. It's human nature to want to do what's popular and it can be very seductive for fund managers and speculators to join whatever trend is working. The longer a trend remains in place, the more followers it gathers, and the more entrenched it becomes; the current bull market is long by historical standards. This 6.5 year run compares to the post-war average of 4.5 years. From the lows of March 9, 2009, the S&P has risen by 215%. Prior to the correction in August 2015, we had gone 44 months without at least a 10% decline in the indexes. This is extremely rare, as corrections typically occur about every 18 months. So, what has been the primary driver of this bull market?

We see the hand of the central bank behind this extended period of stable, upward sloping markets. As the Fed bought trillions of dollars of outstanding Treasury bonds and other fixed income assets, to be held on its balance sheet, this poured newly minted cash into the economy. The surety of central bank support month after month and year after year since 2009 has bred complacency about market risk. Every measureable dip in stock prices was assumed to be fended off with additional government money. This lack of fear promoted a smooth, steady, upward trend in stock prices and an unprecedented period of low volatility. This is a perfect environment for trend following strategies, but a much more difficult one for discerning buyers like Hutchinson Capital.

In the early-mid 2000's, demand from China to build up its infrastructure fueled global economic growth. This created a massive upward cycle in commodity prices, and investment into emerging markets, while causing a decline in the US dollar (as global investors saw better opportunities for growth in other countries). As that trend has waned, the global economy has sputtered. Despite central banks' attempts to spur growth, the rate of US GDP growth since 2007, has been lower than the pre-recession levels.

This chart shows how weak US growth has been relative to history, as measured by GDP (Gross Domestic Product)



Why is US Economic Growth So Scarce?

The US Federal Reserve responded to the 2008-2009 economic crisis and spectre of deflation by experimenting with a broad range of financial schemes to stimulate the economy. Since beginning this liquidity injection policy, they have added over $4.5 trillion dollars to the global financial system through various asset purchase programs.

Initially seeking to avoid another depression and to alleviate joblessness, the Fed's original goals seem to have been replaced by a desire to retain the elevated prices of financial assets and residential housing. They also fear the effects that higher rates and the stronger US dollar might have on other countries struggling to avoid recession and pay off debt. Because this experiment has never been tried on such a large scale, the theory underpinning this Fed policy is largely academic. The Fed's hope is that by compelling investors to move capital away from the safety of US Treasury bonds, and into riskier assets like stocks and high yield bonds, the effects would filter down to the real economy. This, in turn, would improve job growth and spark consumer spending. Their parallel ambition in buying longer term bonds was to force down the cost of borrowing in order to stimulate housing demand. Because the price of a bond moves in the opposite direction of its yield, by purchasing massive amounts of bonds, the Fed has artificially lowered the cost of borrowing for both companies and individuals. The reason many investors are concerned is due to the sheer size of this untested policy, coupled with the ambiguity surrounding the Fed's ultimate objective; despite accomplishing their original goal of getting US unemployment to 6.5%, interest rates remain negative on a real basis. In fact, at the government bill auction on October 6, 2015, for the first time, investors were willing to buy 3 month US Treasury Bills at 0% interest. This suggests to us that the markets do not foresee any rate increases by the Federal Reserve for the remainder of 2015. Despite central bank efforts over the past decade, high asset prices have not translated into higher levels of economic growth.

An unintended consequence of forcing so much money into the financial system has been the growth of computerized trading. Putting so much money to work in the equity markets is not easy but, as always, Wall Street has adapted. It has fostered an explosion of systematic trading, much of it based on automated themes such as the trend following scheme mentioned earlier.

The Search for Growth

This persistent paucity of genuine economic growth since the 2008-2009 recession has prompted investors using trend following strategies to crowd into the stocks of companies promising to deliver superior growth. Prominent among these are speculative technology and biotech companies. But what happens to the prices of such popular stocks when investors begin to doubt the strength of the trend they are following? An example would be the recent activity in biotech stocks. The NASDAQ Biotech Index began its rally in April 2014 at 2,271, peaking in July 2015 at 4,166 (a rise of 83%). The mere suggestion by an aspiring politician of possible future government action to moderate drug prices caused the index to rapidly decline by 27%. Because the lofty valuations were supported only by promises and speculation, any doubt of its realization caused immediate abandonment by trend following speculators.

While it's generally true that things that are rare or scarce often do come at premium prices, stocks are not classic cars or works of art. The growth they promise must be based on sound business considerations and management should be cognizant that growth comes at a cost that is measurable. Just because we buy value doesn't mean we don't also like our companies to grow. But not all growth is good growth, and our portfolio companies must get their growth on the cheap. Preferably, growth comes from cash flow generated internally, by assets already on the company's balance sheet. But sometimes companies must get growth capital from outside sources—by issuing stock and bonds or borrowing from banks. This growth capital, or fuel, is then used to buy assets upon which a company seeks to generate revenue and earnings. Management's ability to convert each dollar of new capital into free cash flow is a measure of their skill. As investors, we must evaluate a company's ability to deliver on its growth promises, and then decide how much we're willing to pay for that.

Contrarian Mindset

Our investors need not fear that we will be seduced by the latest investment fad and overpay for speculative growth...it's simply not in our DNA. Ideally, we like finding companies that we think have genuine growth potential but have been abandoned by investors because of some short term problem. In the current market environment, we are seeing these opportunities emerge in energy and basic materials. Within energy, we have recently been investing in companies whose businesses are primarily related to oil.

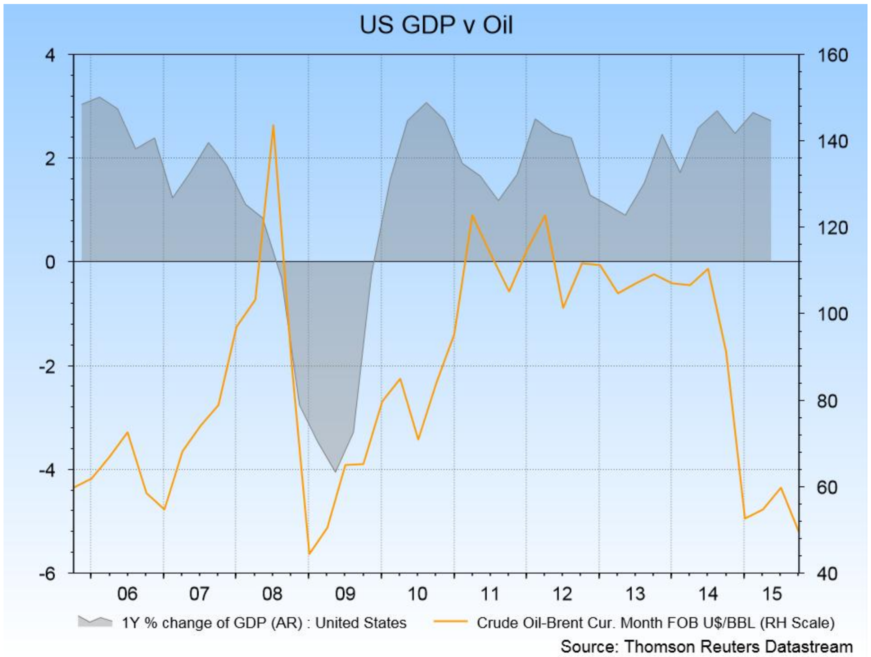
Since June 2014, oil prices have declined by 55%, prompting a 58% reduction in North American rig counts. The decline in drilling activity has negatively affected the stock prices of our energy holdings, but it has not caused permanent value impairment. As a result, we are using this opportunity to selectively add to our energy positions.

Despite this severe decline in the price of oil, OPEC's largest producer, Saudi Arabia, continues to produce at peak levels of over 10mm barrels per day. This aggressive production has been persistent over the past 10 months but we believe it's a tactical strategy rather than a permanently high plateau. These low oil prices are adversely affecting Saudi Arabia's ability to fund its government expenditures; 85% of Saudi government revenue comes from oil. They have extensive social welfare programs and they are currently engaged in military actions in Yemen. As bubbling social tension precludes austerity, the Kingdom was recently compelled to sell government bonds for the first time since 2007. They sold $5.0 billion in August 2015 with plans to sell an additional $22 billion before year-end. Data we have seen indicates that the breakeven price of oil necessary for Saudi Arabia to balance its budget is over $87 per barrel, compared to the current WTI price of $47[1]. We infer from this that their willingness to suppress prices has a limited lifespan.

The chart below shows the relationship between US economic growth and the price of crude oil. It's clear that when the US economy is growing, it supports oil demand. While

[1] This should not be confused with the Saudi's cost of production, which is thought to be among the lowest in the world at between $10 and $20 per barrel.

it's true that, as a country, in recent years, we have become more efficient users of fossil fuels, the odd dislocation that began in 2014 supports our view that the production strategy being used by the Saudis is not going to be sustainable over time, and the negative effect on our stocks is a temporary reaction to the temporary overproduction of crude oil.



We're Stock Pickers not Economists

We've discussed a lot of big picture issues and macro-economic factors, but we are, first and foremost, investors in high quality individual companies that we think offer extraordinary value. We use a long term investment horizon, and while we do not base our investment decisions on economic factors, there are times when such factors do negatively affect the prices of our portfolio companies.

At Hutchinson Capital, we have had to be patient recently as markets have marched higher based on trends that have little to do with company fundamentals. Our long term success has been due, in large part, to an adherence to our value-oriented investment process, and being patient is merely a sign of our dedication to the preservation of your capital. If being disciplined means missing the latest trend, and underperforming in the short term, it's a price we bear willingly in order to succeed unconventionally over the long run.

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