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INVESTMENT PERSPECTIVES

Value Investing

With the recent turmoil in the stock markets, many investors today are concerned about investing in stocks. With the downturns from March 2000 through October 2002, and again from October 2007 through March 2009, investors have been reviewing their investment options. In this Investment Perspectives, we wish to explain why we believe that a commitment to investing in value stocks is a very successful way of growing your portfolio over the long term.

In selecting stocks to buy, we utilize an investment process that we have fine-tuned over the past 16+ years. From a universe of thousands of stocks, we select only a few to research in-depth before deciding whether or not to take a position in any specific company. We believe that our investment process enables us to select under-valued, high-quality stocks for our clients' portfolios.

Stock Market Performance Since 1926

We went back to 1926, using data from Ibbotson's 2011 SBBI Classic Yearbook, to get a sense of stock market performance over the past 85 years. During this timeframe large company stocks had an average annualized return of 9.9%, intermediate term government bonds returned an average annualized return of 5.4%, and inflation averaged 3.0% per year. The table below shows these annualized returns by decade.

	1930s	1940s	1950s	1960s	1970s	1980s	1990s	2000s
Large Company Stocks	-0.1%	9.2%	19.4%	7.8%	5.9%	17.6%	18.2%	-0.9%
IT Government Bonds*	4.6%	1.8%	1.3%	3.5%	7.0%	11.9%	7.2%	6.2%
Inflation	*-2.0%*	*5.4%*	*2.2%*	*2.5%*	*7.4%*	*5.1%*	*2.9%*	*2.5%*

Source: Ibbotson SBBI 2011 Classic Yearbook. * Intermediate-Term Government Bonds.

An observation from the data indicates that stocks fall in and out of favor. In the 1980s and 1990s, for example, large company stocks averaged annualized returns of 17.6% and 18.2%, respectively, well above historical averages. With the benefit of hindsight, a good time to invest would have been in the mid-1970s after the steep bear market of 1973 and 1974. More recently during the decade of the 2000s, large company stocks have generated a negative 0.9% annualized return, well below the long-term average. Some observers have dubbed this the lost decade of equities. (Note that these are the results for large company stocks in the S&P 500 Index, and not for Hutchinson Capital Management portfolios).

We know from behavioral finance that investors tend to extrapolate performance trends into the future, in both good and bad markets. After the early 1990s, stocks became overpriced, in our opinion, reaching a P/E (Price/Earnings ratio) of about 33, more than double the long term average P/E of about 15. In other words, it may be implied that above average returns during the 1980s and 1990s were borrowed from the

decade starting in 2000. In early 2000, after outsized returns during the latter part of the 1990s, investors should have realized that returns and valuations were unsustainable. Fast forwarding to today, investors could be expecting subpar returns of the past decade to continue into the next decade. With expectations and stock valuations at low levels today, we do not agree. At the end of the third quarter, the dividend yield on the S&P 500 Index was 2.41% while the yield to maturity on the U.S. 10-year Treasury note was only 1.92%. Based upon yields, at current levels stocks appear more attractively valued relative to bond alternatives.

Benefits of Holding Stocks

We believe that there are many benefits to holding stocks as compared to other types of investments. These include dividends, liquidity, and as inflation hedges.

Inflation Protection

Preserving the real or inflation adjusted purchasing power of assets is a critical and universal goal for investors. Stocks represent ownership stakes in companies and have historically been a good way of hedging against the negative impact of inflation. Whether this will continue to be the case in the future will depend upon the ability of companies to translate rising costs (i.e. inputs such as raw materials and/or labor costs) into higher prices for the end consumers. In other words, companies that deliver value-added goods and services are in a much better position to command "pricing power." By contrast, investments which provide a fixed rate of return are vulnerable to a rising inflationary environment as the purchasing power of the fixed return is eroded over time.

Liquidity

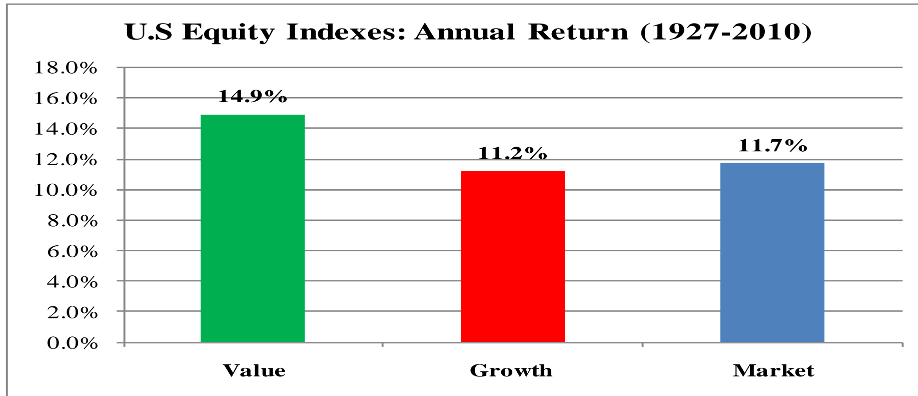
Liquidity refers to the ability to buy or sell an investment quickly without a substantial price concession. An investment's liquidity is a function of several factors including the number of buyers and sellers, transaction costs associated with buying and/or selling, and how difficult it is to value the investment. Generally, art, antiques, private equity, venture capital, and residential and commercial real estate are significantly less liquid than the stocks of large companies. The types of companies HCM invests in are typically very liquid – there are large numbers of buyers and sellers (on exchanges such as the New York Stock Exchange or Nasdaq), transactions costs to buy and/or sell stocks are low and there is price transparency – anyone with a computer or a newspaper can easily obtain the price of a stock.

Dividends

While not all stocks do pay dividends, by far most of the stocks that Hutchinson Capital buys do pay a dividend. For these stocks, the total rate of return on a stock investment has two components: 1) change in price for the investment alone (e.g. stock purchased at $20 per share and sold for $30 per share would result in a capital gain of $10 per share), 2) income from the investment alone (e.g. stock purchased for $100 per share and pays annual dividends of $4 per share would have dividend yield of 4%). While many investors tend to focus solely on the capital appreciation potential of stocks, the income component should not be overlooked. As noted previously, large company stocks generated total returns of 9.9% annualized from 1926 through 2010, and income or dividends accounted for over 40% of these returns. The income component of return tends to be more stable because companies typically are reluctant to cut their dividends and usually only do so as a last resort.

A Case for Value Investing

A careful review of historical market returns demonstrates that a value approach has outperformed both a growth approach and the broader market over a long time. While investment styles fall in and out of favor, the chart below indicates that a value approach not only outperforms growth and the market but that a growth approach also underperforms the market. Why is the value approach's outperformance so pronounced? It boils down to preserving capital (avoiding significant losses) and the power of compounding returns over long periods of time.



Source: Ibbotson SBBI 2011 Classic Yearbook; Kenneth R. French Data Library. Value = Fama/French Large Value Stocks; Growth = Fama/French Large Growth Stocks; Market – NYSE/AMEX/NASDAQ Total Value Weighted Index.

Value investors (such as Hutchinson Capital) focus on stocks with low price multiples (low price-to-earnings, low price-to-book, low price-to-cash flow, etc.). The main risk for value investors is that a stock is priced at a discount for a good reason. By contrast, growth investors generally focus on stocks with high past and expected future earnings growth. The main risk for growth investors is that the future earnings growth does not materialize as expected. In the end, value prevails over growth because purchasing stocks at lower prices allows for a greater margin of safety.

As renowned value investor Seth Klarman notes, "Greedy, short-term oriented investors may lose sight of a sound mathematical reason for avoiding loss: the effects of compounding even moderate returns over many years are compelling, if not downright mind boggling." It is very difficult for investors to recover from even one substantial loss, and growth investors are simply more likely to incur such a loss given their propensity to buy at higher prices. Klarman astutely observes that "an investor who earns 8% annual returns over a decade, for example, will, perhaps surprisingly, end up with more money than an investor who earns 10% a year for nine years and then loses 15% in the tenth year."

Another interesting way to assess the value and growth investment styles is to compare returns for each decade. The table below reveals that value consistently outperformed growth in almost every single decade. However, value did underperform growth when it was deeply out of favor as an investment style during the 1930s (Great Depression) and the 1990s (technology bubble).

Importantly, a value approach will ultimately outperform a growth approach during long periods of time and across multiple economic cycles.

Style	1930s	1940s	1950s	1960s	1970s	1980s	1990s	2000s
Value	-5.5%	17.2%	22.2%	10.7%	12.2%	20.2%	13.9%	0.3%
Growth	1.5%	7.3%	17.6%	7.9%	3.4%	15.8%	19.9%	-1.8%
Difference	*-7.0%*	*9.9%*	*4.6%*	*2.8%*	*8.8%*	*4.4%*	*-6.0%*	*2.1%*

Source: Ibbotson SBBI 2011 Classic Yearbook. Value = Fama/French Large Value Stocks; Growth = Fama/French Large Growth Stocks.

Misconception on Buying and Selling

Many investors believe the best time to buy stocks is when the economy is doing well and there are no clouds on the economic horizon. This would seem to make sense as good economic conditions should continue in the future. Unfortunately, using history as our guide, they do not. The stock market is an indicator of a market of investor's future perception of earnings, not today's. When the economy is strong and the future looks bright, you will likely have to pay *very high prices* for the company's perceived future earnings.

For example, in 2000 the market's perception of General Electric was that its future could not have been better. The stock was trading at $60 a share, almost 40 times its then current earnings per share. As reflected in this very lofty valuation, we believe that the market was pricing in tremendous future growth. As is often the case, the future did not work out as planned and the stock missed its expectations for growth and along with a mismanaged credit unit fell all the way to $6 per share.

As value managers we would rather find high quality out-of-favor stocks where expectations are so low that when the company is able to turn around their situation, the upside is tremendous. Even if a company continues to struggle this is often factored into the price of the stock. Warren Buffet puts it this way:

> *"I don't look to jump over 7 foot bars: I look around for 1 foot bars to step over".*

GE had a 7 foot bar; they missed badly and provided poor results for years to come. The same can be said of waiting to buy stocks in a good economy. By the time you start to invest, all the great values will have disappeared. In some cases the stock market has started to price in those one foot bars and we are starting to research these opportunities.

Conclusion

We believe that high quality value-oriented stocks when chosen wisely at low prices will outperform other asset classes over market cycles. We believe that the evidence that we have presented in this paper supports this point. Hutchinson Capital's process has served our clients well over the years. We continue to refine our research process and now have a full-time research analyst with the firm. While we may experience turbulence in the markets for some time, we strongly believe that our stocks will perform well in the coming years.

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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