HUTCHINSON
CAPITAL
MANAGEMENT

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INVESTMENT PERSPECTIVES

<u>What's the Difference between Price and Value?</u>
"In the short run, the market is a voting machine but in the long run, it is a weighing machine." – Benjamin Graham

The message in this quote by the legendary value investor is the notion that investor mood and sentiment govern short term price movements while fundamentals determine the genuine value of things. We label these emotion-based gyrations in price as cyclical effects. The longer term, fundamental factors that determine value are thought of as secular.

Throughout this Investment Perspectives, we will detail how price vs. value often comes down to cyclical vs. secular. These issues are consistently threaded throughout the economy, the financial markets, each sector, and ultimately, individual stocks. We will explain how these forces create investment themes, shape our analysis, stock selection, and risk management. For example, how does the secular trend of a burgeoning global middle-class affect growth across the world economy? Literally billions of consumers around the world are gradually achieving an income level that will allow them to enjoy the "luxuries" that we in the developed world consider necessities. These masses of consumers are increasing their protein consumption, buying automobiles and air conditioners. We look at that trend and consider its effect on agriculture, infrastructure, transportation, and natural resource consumption. Demand for all these products will enjoy long term sustained growth, but the current cyclical slowdown in China is causing temporary demand weakness. This investor focus on the short term is causing uncertainty and has driven commodity prices and their related companies to irrationally low levels.

<u>Cyclical vs. Secular</u>
Cycles are temporary and tend to be defined by how long they last—on average. Even though the word secular derives from the Latin word "saeculum" (long period of time), such trends are governed neither by specific time frames nor degrees of magnitude. At Hutchinson Capital, the investment horizon for our typical stock investment lasts longer than most cycles, and because we invest based on fundamentals, we evaluate secular factors more intensely.

Despite this focus, we have to consider both the cyclical factors affecting a stock's price, as well as the secular forces impacting a company's intrinsic value. By intrinsic value, we mean the value of a company that we have derived through our fundamental financial analysis. We seek opportunities where cyclical pressures have pushed the stock's price well below fundamental value. For example, the cyclically depressed price of oil has created value across the energy universe. We know that the secular demand for oil will increase with demographic trends, such as the natural growth of the world's population and its developing middle-class.

Some other current examples of global trends that may create opportunities include:

- **Secular**: increased demand for protein is driving higher consumption of agricultural products
- **Cyclical**: recurring droughts in major agriculture producing regions have caused supply/demand imbalances in livestock while bumper crop yields depressed prices across the grain complex

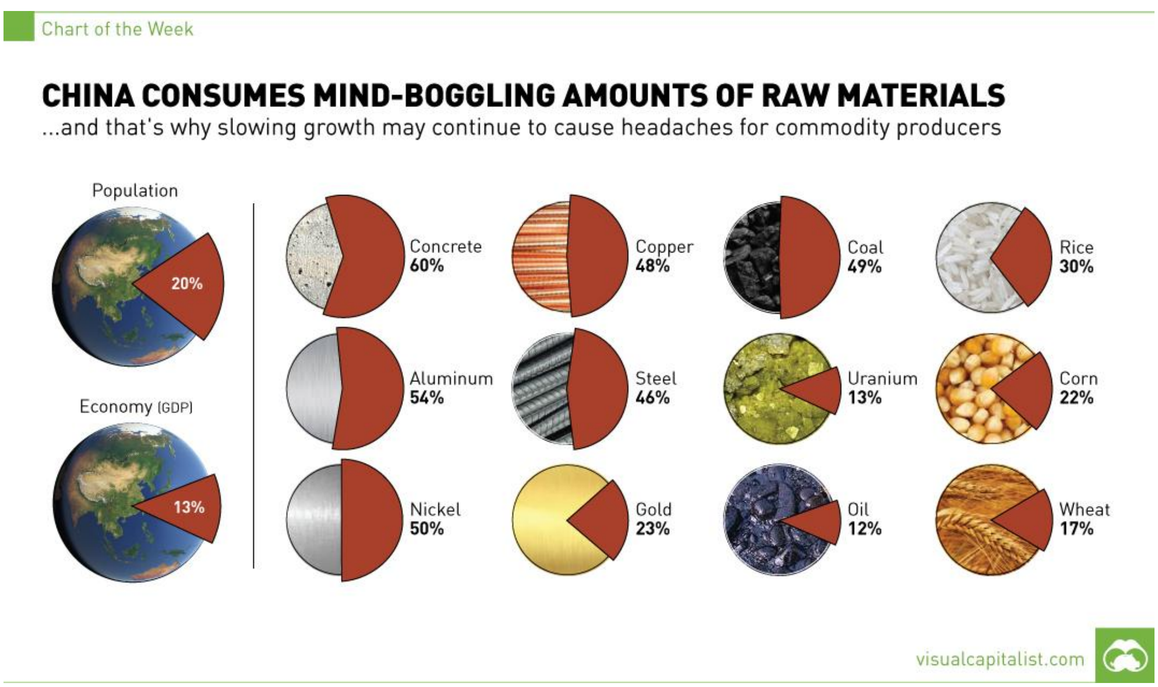
- **Secular**: the digitization of information has changed the way it is distributed; this has caused secular declines in the printed newspaper business and in the sale and processing of photographic film; we avoid industries that we believe are in secular decline

- **Secular**: the rise of eCommerce has changed the way people shop and the way goods are distributed around the world; this has caused a secular increase in demand for containerboard packaging and for parcel delivery services within the transportation sector
- **Cyclical**: containerboard producers and waste disposal companies are impacted by the cyclical trends in consumer spending

- **Secular**: the secular decline in coal consumption has put the companies that mine the product into secular decline; the switch to natural gas as a source of power generation will be a long term secular trend
- **Cyclical**: the price of electric power is cyclically depressed due to the low coal prices; natural gas prices are also weak due to temporary imbalances in supply/demand; coal is the most cost effective means of generating power, so once it's fully phased out, both power prices and natural gas prices will eventually skyrocket

The Most Significant Current Secular/Cyclical Trend

Over the last 20 years, the world economy has relied on the Chinese economic growth engine. The 1.4 billion people living in the world's most populous country account for 13% of global GDP. However, in the commodity sector, China's importance is magnified several fold. Because China consumes so much of the world's materials, energy, and food, the fear that their growth is slowing or changing in complexion is a source of terrible anxiety for investors. To give you some prospective on the magnitude of this event, in just the last three years, China has consumed more concrete than the United States did during the entire 20th century. China is foremost among the countries experiencing development of a middle-class, so their long term demand for many of the world's raw materials will continue to be tremendous.



A cyclical phenomenon prevalent in markets today is the role that central banks have played in distorting key fundamental indicators of economic and financial sector health. The distorting effects of intervention have gradually infected most every developed economy causing a massive misallocation of capital. This is important because the US was the first to begin the liquidity scheme and is now the first to reverse course. With the US raising interest rates at a time when most other countries are cutting, the US dollar is strengthening. This dollar strength puts competitive pressure on US companies by making US-made products more expensive to foreign consumers. This, in conjunction with a transitioning away from government support for the markets, is causing investor uncertainty.

While the price gyrations caused by this uncertainty are cyclical, secular market cycles turn on fundamental valuation rather than sentiment. When markets are described as being "expensive" or "cheap" the metric generally used to measure that is the price to earnings ratio (P/E). A simple way to think about how this ratio is used is to consider a scenario where we buy a share of stock in a company for $50 per share. If our company earns $2.00 per share in earnings (EPS), we will have paid a P/E of 25x. Furthermore, at this $2.00 annual level of EPS, it will take the company 25 years to return our $50. Many factors affect the P/E multiple that investors are willing to pay; chief among those are growth and inflation. For example, if our company is able to grow its EPS faster, we would get our $50 investment proceeds back sooner. This is important to us because a dollar received today is always more valuable than one received later. Along those lines, if EPS jump to $5.00 per share, it will only take 10 years to get repaid and the P/E multiple drops to 10x. Say on the other hand, inflation goes up by more than we expected, the value of the earnings we will receive in future years will be worth less because our money is losing its purchasing power; under these circumstances, we would be less willing to pay 25x earnings. It is only when the P/E ratio on the market reaches extremes that a secular trend will reverse. Currently, the multiple on the S&P 500 is 21.5x.[1] This compares to an average of 16.6x going back to 1871. Perhaps more enlightening though is the fact that over this 145 year period, the multiple has only been higher 8% of the time.

Over the past 100 years, the market has had only four secular bull and bear markets[2], but cyclical declines, or "corrections," of 15%-20% have been numerous. These cyclical ups and downs in prices can impair our performance in the short term, but our sound judgment and rigorous analysis produce consistent returns over the long run. Fund managers regularly use the phrase "long term," but what does this really mean? At HCM, it's as long it takes for the price of a stock to converge on the value of the company as determined by our fundamental analysis. The trick is finding opportunities where the spread between price and value is wide but not for good reasons.

As contrarians, we don't take an opposing view by assuming others must be wrong, only that they have different expectations and/or priorities. Generally, that revolves around different time horizons and sensitivities to short term price volatility. The greatest opportunities for our type of investments occur when the consensus view is poorly focused while also being most uniform. These situations are self-reinforcing and, at the apex of uniformity, the price vs. value divergences are greatest. It's at these points that the pressure to conform is greatest.

2015 was a frustrating year for value managers and the chart below encapsulates much of it. Within this chart we have captured the divergence between the broad market (S&P 500), and the four stocks comprising what is labeled: the F.A.N.G (Facebook, Amazon, Netflix, and Google). In extreme cases like the FANG, the irrational behavior becomes absurd. Recalling our example of the P/E multiple, considering NFLX, with its multiple of 581x, if we gave them $120 to buy a share, we would have to wait 581 years to get all of it back. These stocks have grown so large that they've been a major cause of the unusual dispersion between the S&P 500 and its equal-weighted twin.[3] For 2015, excluding dividends, the S&P 500 was down 0.73%, but the equal-weighted index was down 4.11%. This is a significant difference for an index with a total value of nearly $18 trillion dollars.

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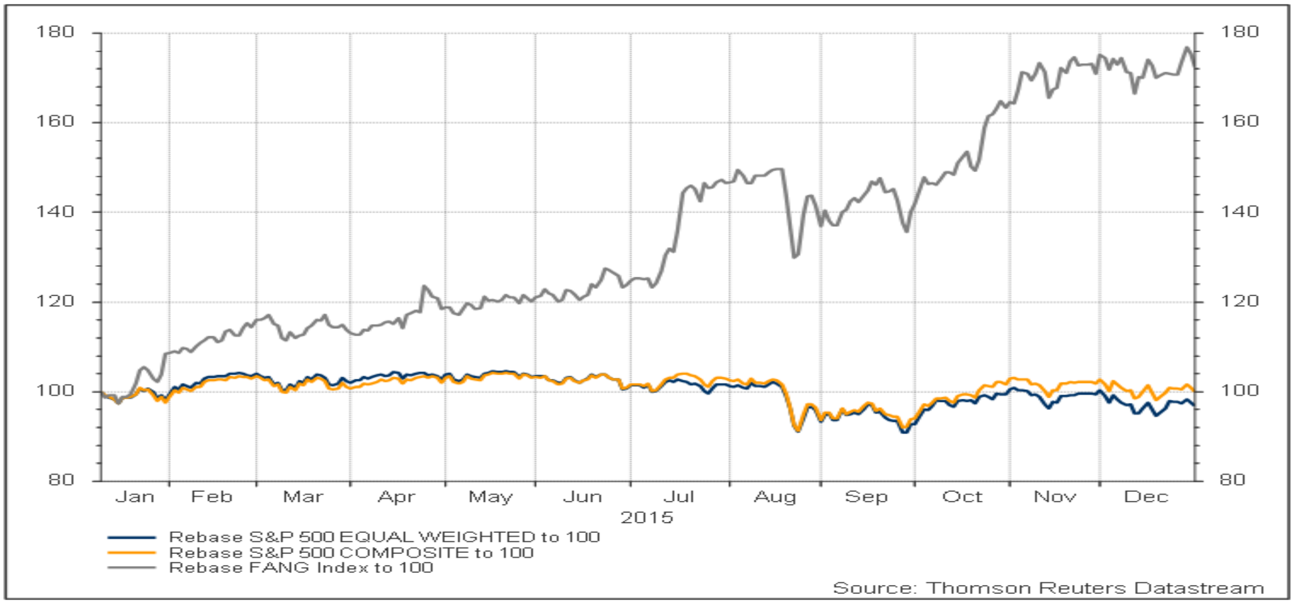
[1] 2,050/$95.38 (=) 21.5x

[2] Secular bear market troughs: 1921, 1949, 1982, and 2009

[3] The S&P 500 index is a market weighted index such that a single company's price change has an impact on the price of the overall index that is directly proportional to its relative market capitalization.



Over the last 18 months, the cumulative market capitalizations (or prices) of the four companies that comprise the FANG grew to total as much as all 40 companies in the S&P 500 Energy Sector. When the prices of four companies equal the cumulative prices of the 40 most important energy producing companies in the US, common sense suggests that there's a wide disconnect between price and value. To think of it another way, consider if all of sudden these energy companies vanished. We would lose the ability to generate electricity, drive our cars, heat our homes, or communicate. What effect would that have on our lives? This conveys the concept of value. But if the four companies comprising the FANG went away it might be inconvenient for a bit but, ultimately their disappearance would be totally irrelevant to our standard of living. Not surprisingly, we have been finding value in the Energy sector.

	Market Cap ($bil.)	P/E	FCF to EV (%)	P/S
Facebook	$295b	49x	1.8%	18x
Amazon	$300b	340x	1.6%	3.0x
Netflix	$52b	581x	-1.7%	7.8x
Google	$517b	25x	3.1%	7.3x
FANG	**$1,164b**	**n/a**	**n/a**	**n/a**
Energy Sector	**$1,163b**	**31x**	**n/a**	**1.1x**

S&P Energy sector is 6.5% of the total index (6.5% of $17.9T)

<u>Conclusion</u>

As always, each investment we make is carefully considered in terms of our risk-adjusted return expectation. With capital preservation in mind, we evaluate the potential upside only after considering how much we might lose if we're wrong. We rely on the market's hyper-focus on short term cyclical forces to create opportunities by moving the prices of attractive companies to deep discounts. The greatest risk management tactic is to buy high quality companies at low prices regardless of cyclical trends.

As of December 31, 2015, Hutchinson Capital Management (HCM) held:

0 shares of Facebook (FB)
10 shares of Amazon (AMZN)
42 shares of Netflix (NFLX)
10 shares of Google C class (GOOG)
10 shares of Google A class (GOOGL)

As of December 31, 2015:

Facebook (FB) closed at $104.66
Amazon (AMZN) closed at $675.89
Netflix (NFLX) closed at $114.38
Google C class (GOOG) closed at $758.88
Google A class (GOOGL) closed at $778.01

As of December 31, 2015, the following were the ten largest holdings of HCM:

Name of Issuer	% of Equity Portfolio	12/31/2015 Closing Price
MARKEL CORP COM	8.3%	883.35
WELLS FARGO & CO	6.6%	54.36
INTEL CORPORATION	6.3%	34.45
CHUBB CORPORATION	6.1%	132.64
GENERAL MOTORS CORP.	5.9%	34.01
KOHL'S CORPORATION	5.9%	47.63
CARNIVAL CORPORATION	5.5%	54.48
JOHNSON CONTROLS INC	5.3%	39.49
CVS CAREMARK CORPORATION	5.0%	97.77
NATIONAL OIL WELL VARCO	4.9%	33.49

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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