Hutchinson Capital Management

Investment Discipline

April 4, 2013

When investing in any type of asset class (real estate, commodities, collectibles, stocks, or bonds) it is imperative that investors have a clear and consistent investment philosophy that focuses on the long term. This consistent investment philosophy should see through the short-term clouds and focus on the fundamental underlying issues. We acknowledge that confusion and concerns abound today. Investors are concerned about Europe, our expanding government debt levels, and ramifications of the 2008-2009 financial crisis to name a few. As well, many investors who fled to the apparent safety of cash and bonds are now wondering if they should dip their toes back in the stock market to achieve better returns. While we are keenly aware of these concerns, we must not let our emotions drive the investment decision. Investment opportunities arise when investors freeze-up, panic, or sell. At Hutchinson Capital, we believe following a disciplined investment philosophy that tries to mitigate or eliminate emotional decision making is critical.

Where Does Confusion Exist Today?

It seems that several macro concerns are top of mind today. The most recent stock market rally began following a July 2012 speech by European Central Bank (ECB) President Mario Draghi who declared that the ECB is willing to do 'whatever it takes' to save the Euro. This statement combined with liberalized collateral rules allowing European banks access to cheap funding, ultimately lowered the borrowing rates for Spain, Italy, and other struggling southern European economies. While the actions have calmed markets, the real economies of Italy, Spain, Greece and others remain troubled with unemployment rates continuing to increase throughout 2012 and early 2013, as evidenced by the chart below.

Unemployment Rates in Selective Countries

Country	May 2012	Aug 2012	Oct 2012	Dec 2012	Jan 2013
European Union (27 countries)	10.4	10.5	10.7	10.7	10.8
Germany (until 1990 former territory of the FRG)	5.5	5.4	5.4	5.3	5.3
Ireland	14.8	14.8	14.7	14.7	14.7
Greece	23.8	25.4	26.3	26.4	-
Spain	24.8	25.5	26.0	26.1	26.2
France	10.2	10.3	10.4	10.5	10.6
Italy	10.4	10.6	11.2	11.3	11.7
Cyprus	11.6	12.4	13.9	14.6	14.7
Portugal	15.5	16.2	16.8	17.3	17.6
United States	8.2	8.1	7.9	7.8	7.9

Source: Eurostat

British economist Roger Bootle, one of the more outspoken European critics, has said that German recommended austerity measures combined with high debt levels could take a decade to correct imbalances.[1] He also openly notes that France, Germany's closest partner and supposed pillar of strength in North Europe, more closely resembles its southern neighbors than Germany. The recent flare-up in Cyprus, rather than being an isolated incident, could instead be a reminder that the fundamental flaws of the entire European block have not been addressed.

Obviously, Europe is not the only macro concern. In 1939, Winston Churchill famously described Russia as "…a riddle, wrapped in a mystery, inside an enigma." If Churchill was alive today and running an economic consulting firm, he might attribute the same quote to China's current economic situation. Reported economic data continues to appear strong but many, including noted short-seller Jim Chanos, have expressed concerns over a possible housing bubble, faulty economic statistics, and numerous other issues. Investment accounts for approximately 50% of China's Gross Domestic Product (GDP), a level meaningfully higher than other economies.[2] According to Chanos, this investment has strengthened reported GDP data, but he notes that China's GDP calculations do not look at final sales but simply production.[3] So if a condo is built but not sold, its construction increases GDP but does not add a productive economic asset. We are not experts on China, but we would venture that a possible 'hard landing' is not priced into current global equity prices.

And of course, the United States has issues. We will save readers the often repeated statistics regarding slower economic growth, unsustainable debt levels, and a dysfunctional political process. Certainly, these concerns are real and there will likely be unintended and unanticipated consequences of recent government and central bank actions over the past several years.

Keeping it all in Perspective

Before reaching for flashlights, canned goods, and moving to a reinforced underground dwelling, we would suggest that investors keep some perspective on macro concerns. As we noted above, there are real, and in some cases troubling, macro related issues present today. This same statement would have been accurate at times over the last 50 years and will also be accurate at times over the next 50 years. The often cited 9-10%[4] realized long-term return on stocks over the last 100+ years incorporates several periods of truly horrible macro events including multiple wars, several recessions, the Great Depression, oil embargos, 20%+ interest rates, etc. We are very confident (but saddened to say) that

[1] July 21, 2012 The Telegraph extract from Roger Bootle's 2012 book *The Trouble with Markets.* Bootle ultimately won the 2012 Wolfson Economics Prize for this work.

[2] November 2012 IMF paper 'Is China Over-Investing and Does it Matter?'

[3] May 2, 2012 interview at Milken Institute Global Conference

[4] Database sourced from Yale's Economic Websites which showed the S&P 500 returned 9.49% annually from 1900-2012, including the reinvestment of dividends.

the next 50 years will also include various conflicts, tragedies, recessions, and inflationary periods. Unfortunately, we do not have any great insight in predicting how macro events will unfold, but we are skeptical that anyone possesses a magical crystal ball that can accurately forecast the future. We would note, however, that patient investors have achieved attractive long-term returns despite the sometimes negative headlines. We suspect this will continue to be the case going forward.

Dealing with Uncertainty

Most importantly, by following our consistent methodology, we believe that attractive investments will present themselves regardless of what the future holds. Benjamin Graham is considered by many as the father of value investing. He once said that "the essence of portfolio management is the management of risks not returns", likewise, as value investors we focus on the preservation of capital first and then the growth of capital over the long term. These objectives can only be accomplished by having a disciplined process, exhibiting patience, and then executing on that process in order to make decisions that may seem contrary to the crowd.

It might be helpful to use an example. Today, we face an environment where bonds, even ones with long maturities, have very low yields. There are many instances where we can find a stock that has a higher dividend yield than the yield on the 10 year Treasury bond, and thus, on a relative basis we can say that stocks are more attractive than bonds. As investors, we feel that relative attractiveness is not enough to make an investment decision. In order to buy a business, that business must be attractive on its own merits, or said another way, on an absolute basis. To determine if a business is attractive it should not only be a well run operation, but also be purchased at a reasonable price.

We continually search for businesses which can consistently generate strong cash flow, understanding that there will usually be some degree of variability in any given year. As we familiarize ourselves with all aspects of a prospective company's business, we attempt to think about how cash flow could vary if the competitive dynamics of business change or if the overall economic environment deteriorates faster than anticipated. This analysis allows us to better judge the sustainability of cash flows over time. Additionally, we try to make judgments on management teams by evaluating how they are compensated, how they allocate capital, and whether or not we are comfortable partnering with the team going forward.

The second aspect related to the attractiveness of a business is the price we would pay. In order to decide the price we would pay for a business we must first decide its intrinsic value. We can arrive at the business value in a few different ways such as the free cash flow of the company or the value of the assets it owns. By following a value investment philosophy of purchasing companies with strong business models at prices below their intrinsic value, we believe that investors should be able to preserve and grow capital over the long term.

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Adhering to a disciplined investment philosophy for investing in common stocks and bonds over long periods of time is essential for achieving investment success. Since 1995, we have adhered to a value philosophy - high quality investments at attractive valuations with a three to five year time horizon**.** This disciplined approach to investing in common stocks and bonds over long periods of time is essential for two goals: preservation of capital and compounding of principal. Without a disciplined investment process neither goal is likely to be achieved.

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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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