HUTCHINSON CAPITAL MANAGEMENT

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INVESTMENT PERSPECTIVES

Why Do We Buy Stocks That Have Been Going Down?

We are often asked by clients, "Why do you buy things that are going down?" This simple sounding question is, in truth, not simple at all. It gets to the heart of what value investing is all about. One must have a certain disposition to be attracted to ideas scorned by most other investors. It requires an ability to be truly thoughtful and stoically patient. And it cannot be done without patient clients who share our vision and trust our process.

Worry top-down, invest bottom-up

This quote from value investor Frank Martin, broadly exemplifies the framework we apply at HCM. We have spent a lot of time in recent writings and conversations with many of you discussing macroeconomic forces that are coloring our investment mood. It is because these forces, which are outside of our control, cause us concern. One area of concern that we have mentioned before is the unknown result of global central banks adding so much money to the financial system. In the seven years following the Great Recession, over $10 trillion dollars have been printed and poured into markets. It's impossible to know the degree of distortion this may have created in asset prices. While these various factors do make us cautious, they do not change the way we analyze individual companies or pick stocks.

Warren Buffett is famed for saying, *"Be fearful when others are greedy and greedy when others are fearful."* Mr. Buffett is referring to the way that stock valuations seem to reflect the moods of investors. We pay close attention to these mood swings because they can determine which stocks grow expensive and which ones become cheap. We do not attempt to time the market, but there are times when a wide variety of inexpensive stocks are hard to find. Fortunately, most of the time, segments of the market rotate in and out of favor. Areas that are in favor grow pricey, and those that are abandoned by most investors become cheap. It is these out of favor areas that present the most attractive opportunities to us. But in today's market, most of the cheap stocks share similar characteristics—namely, they depend upon strong global growth, and that means demand from China. China's growth has slowed recently, but we suspect that if it picks up again, many of these stocks will find their legs. We are analyzing those few companies that have gotten so cheap, and have strong enough balance sheets that if it takes a very long time for China to begin buying again the stocks will hold up fairly well as we wait it out.

So what causes popular stocks to become so irresistible that investors lose focus on fundamentals? Throughout history, there are two things that always seem to be present when investors grow careless:

1. There is a revolutionary technological advancement that investors believe will lead to a new era of above-trend growth that is sustainable into perpetuity
2. This immeasurable growth causes investors to focus primarily on demand while ignoring supply

If a company provides a good or service that will forever face increasing, insatiable demand, that company's stock valuation will know no bounds. As you can surmise, this is never the case, and investors are always sorry when they ignore the risk of competition or the introduction of new sources of supply.

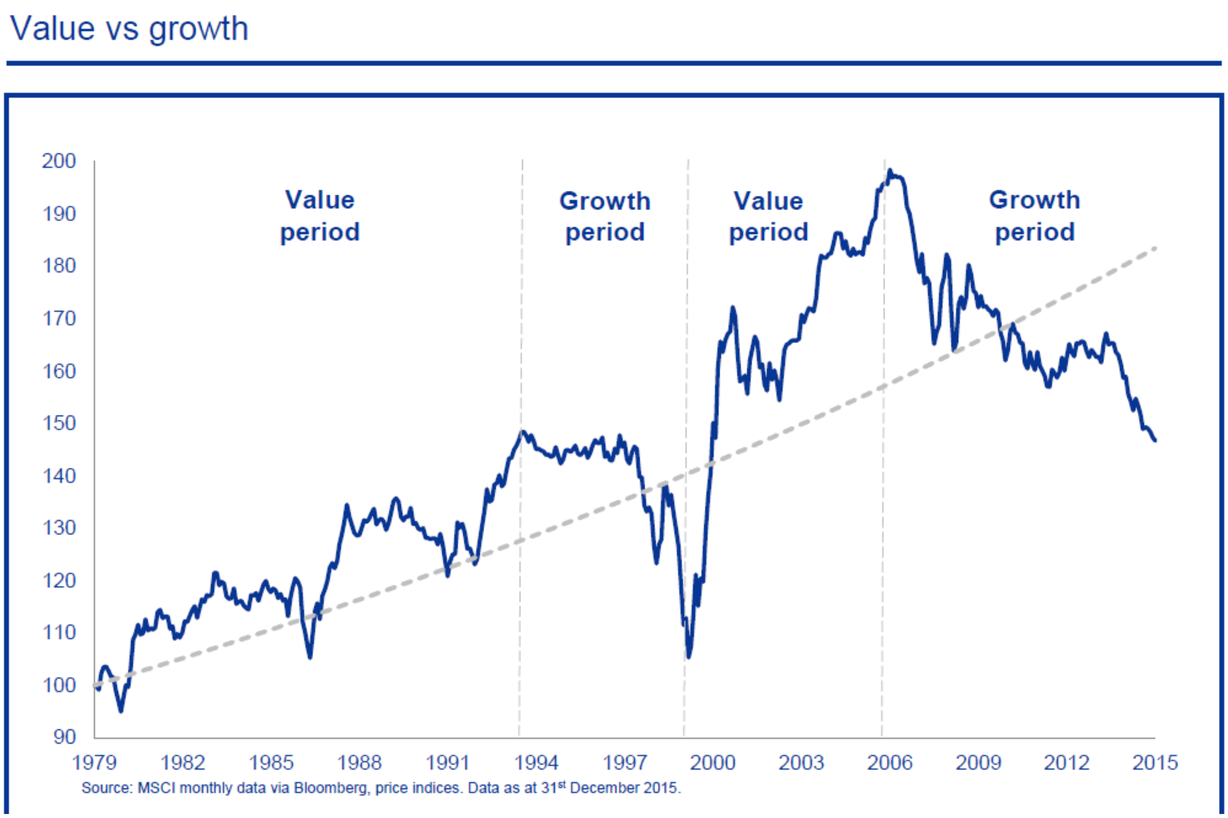
Keeping our emotions in check

Among the greatest challenges for an investor is to avoid becoming too enthusiastic about stocks that have done well, while growing negative on stocks that have performed poorly. Despite the proven evidence that value investing is the superior method, why don't more people do it? Because, it's very hard to do. As one famous value investor describes it:

"…He must deal in values, not in price movements. He must be relatively immune to optimism or pessimism and impervious to business or stock market forecasts. In a word, he must be psychologically prepared to be a true investor and not a speculator masquerading as an investor. If he can meet this test, he will be a member not of the public at large but of a specialized and self-disciplined group."[1]

But how does this translate into the real-world work we do at HCM?

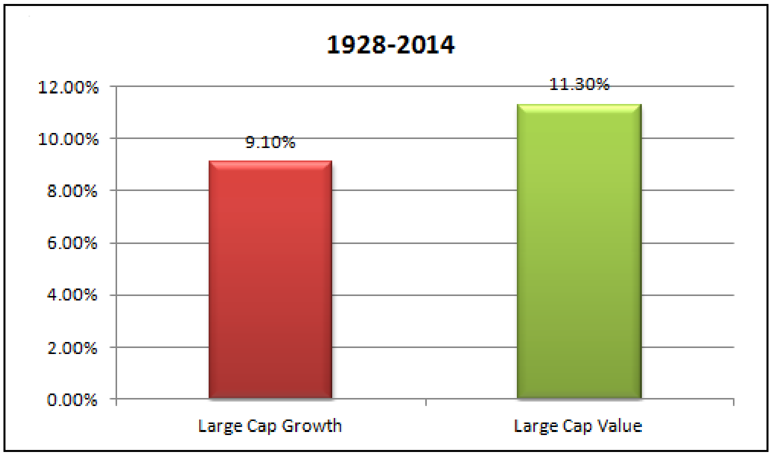
- **We are independent thinkers**: 75% of the time, value investors are involved in stocks that most other investors avoid
- **We have true grit**: a true value investor must be mentally and emotionally capable of suffering extended periods of underperformance and intellectual isolation. 2006-2016 is the longest-ever period of underperformance for Value vs. Growth. As Value investing is proven to outperform over the long run, we expect this abnormally long period of Growth investing preference to reverse soon and reward our patience



[1] Graham, Benjamin. *The Intelligent Investor* (1949, HarperCollins)

Series 1928-2014	Geometric Mean %
Large Cap Growth	9.1
Large Cap Value	11.3

Source: Ibbbotson SBBI 2015 Classic Yearbook



How do we find things are genuinely cheap?
The market as a whole infrequently gets truly cheap and we don't wait around for large sell-offs in order to find investment opportunities. We are always alert to situations in which investors are selling for reasons that are not fundamental. It is during these periods when emotional fortitude is a necessity; when investors sell out of fear or due to liquidation, it usually means the markets are under stress. The ability to step in and take advantage of these rare opportunities is a hallmark of a successful value investor.

Conclusion
We preserve capital by managing risk through the prices we pay. The value mindset dictates that it's what you pay, not the growth you get, that is the biggest driver of future returns. Buying even good assets may be a poor investment and increase our risk of loss if we pay the wrong price; the lower the price we pay the less right we have to be when we want to sell. While we always focus on quality companies, we are particularly careful about a firm's balance sheet if the company is in a business where the price of what they sell bounces around unpredictably. This creates more risk than we like and makes it hard for us to focus on the long term.

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.

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