October 2017

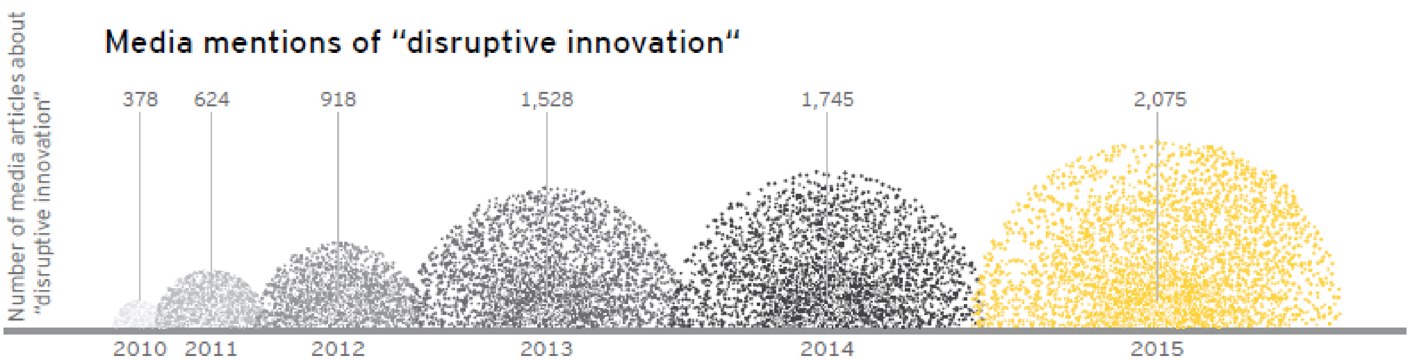
INVESTMENT PERSPECTIVES
The Future is Now

Which is more important: what a company has done in the past, or what it might accomplish in the future? Evaluating how a company's management has dealt with past challenges while strategizing for the future are equally important. It is sometimes suggested that value investors rely on historical data to buy traditional (read: boring) companies, while growth investors look forward and buy innovative (read: exciting) companies of the future. At HCM, our value-oriented investment process employs a *Profitable-Growth*[1] framework. For an investment to fit our framework it must have both a history of solid returns, as well as the ability to grow by investing capital in profitable future ventures. Additionally, we must be able to purchase those assets at a discount to intrinsic value. Intrinsic value is deeply influenced by changes in a company's competitive environment and management's response to it. The competitive landscape is always shifting for all companies, but the speed and degree of that change varies. The most extreme form of change is ***Disruption***. In this Investment Perspectives we will highlight how competition affects our intrinsic value calculation, and describe the disruptive influences impacting our portfolio, our lives, and the financial markets overall.

Because we think this topic is so important and our efforts at adapting to competitive disruption so pervasive in our investment process, we have crafted an addendum to this piece which will be sent under separate cover. Due to its length, we decided to send it separately, and also to make it available on our website. This additional piece is a summary of the case study work that went into our analysis of disruptions related to mobility. In it, we detail the impact on automobiles, transportation, and energy. Combined, these two pieces tie together conceptual investment theories with real-world examples of their application in the construction of our portfolio. The way we process innovation, disruption, and competition through our investment methodology blurs the distinction commonly drawn between the growth and value investment styles.

Competition vs. Disruption

Competition between companies has profound implications for revenue growth and pricing dynamics, which in turn, drive company profit margins. We've spoken often about Competitive Advantage, how companies seek to attain it and how we evaluate its durability. Disruption is a risk that always lurks at the fringes of every company's lifecycle. While it is not a new phenomenon, it takes different shapes over time. Presently, advances in digital Information Technology (IT), are disrupting nearly every industry. Smart industry leaders are adapting and using technology to raise entry barriers and reinforce their market positions. Those companies that are not adapting are under increasing duress.



Source: EY analytics using Factiva database. Figures show number of media articles mentioning "disruptive innovation" in each calendar year, excluding duplicates.

[1] Profitable Growth: all growth has a cost; our value investing framework considers the cost of asset growth as well as the future returns available on those assets.

Because the media focuses primarily on the latest whiz-bang technologies and innovations, today it's common to associate disruption with IT and with Silicon Valley; but the Valley's mantra of creating products that are "better, cheaper, faster" is not necessarily disruptive. Individual products are not disruptive; business models are disruptors. In fact, start-ups with better products rarely succeed unless they are disruptive. For a new entrant to be disruptive, the threatened incumbent's revenue and cost structure must be such that it cannot economically respond. There are two primary forms of disruption: (1) *A New Market Disruption* which addresses a previously unserved market; or (2) *A Low-End Disruption* whereby a simpler, cheaper, more convenient alternative displaces an existing product. Current disruptive trends we are paying attention to revolve around mobility, the sharing economy, and predictive data. When disruptions are significant enough, they can evolve into *Megatrends*.[2] Some current megatrends are urbanization, digitization, and aging populations in developed economies. Urban migration in emerging, formerly agrarian economies, is changing the face of the planet; by 2030, the world's largest 750 cities will account for 60% of global GDP and add 220 million additional middle-class consumers.

We've Seen This Act Before

The human race has dealt with disruption for centuries, and despite its prominence in the media today, we have many lessons from history upon which we can draw. In 1850, a decade before the Civil War, the United States' economy was small—it wasn't much bigger than Italy's. Forty years later, it was the largest economy in the world. What happened in between was the railroads. US railroads linked the east of the country to the west, and the interior to both coasts. All regions of the country now had access to the east's industrial goods; economies of scale were made possible; steel production and manufacturing were stimulated.

Every 60 years or so—a body of technology comes along which profoundly transforms the economy, bringing new social classes to the fore and creating a different competitive landscape for business.[3] There are three primary forces which drive disruption and subsequent megatrends:

1. Technology
2. Globalization
3. Demographics

Technology: Advances in technology have been disrupting business models for centuries. The Industrial Revolution, for instance, eliminated guilds and created massive labor displacement. In our lifetime, successive waves of the IT revolution (PCs, internet, mobile, social) have democratized data, empowered consumers and spawned scores of new industries. The next waves — the Internet of Things (IoT), virtual reality, artificial intelligence (AI), and robotics, promise to be equally revolutionary.

Globalization: Like technology, globalization has been upending the status quo for centuries, going as far back as the 15th century-launch of the Age of Discovery and colonialism. Globalization has accelerated in recent decades, thanks to trade liberalization and emerging market growth. These trends disrupt existing business models by creating new competitors, reordering supply chains and lowering price points. The next waves — including the emergence of Africa and a more multipolar world — will increase complexity and require flexible business models to respond to global shifts.

Demographics: In the decades ahead, relatively high birth rates will make Africa and India engines of economic opportunity. Aging populations will transform everything from health care to real estate. Millennial-dominated workforces will reinvent the workplace. Urbanization will increase cities' economic and public policy clout, even as it strains their ability to grow in sustainable ways. Migration and immigration will have profound impacts on workforces and economic development.[4] All these demographic shifts will require new strategies and business models. Populations in emerging economies are growing fast and need to be fed. From an investment standpoint, we foresee that the only way to grow enough food for our burgeoning civilization is through industrial farming. The only way to efficiently use our limited farmland is to maximize its utilization through proper crop nutrition. Factory farmers understand the importance of crop nutrients and can, more regularly, afford to apply them. We own Mosaic Company (MOS) as a way to benefit from this trend.

Hope, Hype, and Hyperbole

Disruptions and megatrends can become waves of enthusiasm, and as investors, we have to be careful not to get caught up in it. Every past wave has led to a speculative investor craze, during which the tangible investment morphed into a frenzy

[2] A Megatrend is a large, social, economic, political, environmental or technological change, slow to form, but globally impactful. Once in place, they influence a wide range of activities, processes, and perceptions, both in government and society—often for decades.
[3] *The Second Economy*; W. Brian Arthur; The Santa Fe Institute; McKinsey Quarterly
[4] *The Upside of Disruption: Megatrends Shaping 2016 and Beyond*; Uschi Schreiber, Ernst & Young

about making money on money. This results from investors' love of "Lottery Tickets"; those ideas with exciting stories, and prospects of extravagant returns, despite a low probability of success. The allure can be overwhelming, swamping the minds of even the smartest and most experienced investors. This has always been an issue, and historically we just called it greed, but today we have sanitized it into a catchy acronym: *FOMO (Fear of Missing Out*). Filtering potential investment opportunities related to megatrends through our disciplined process keeps us grounded. This is more difficult than it sounds. Rational investors must withstand long periods of "missing out" and potential underperformance, facing criticisms like, *"You just don't get it…" or "This changes everything; it doesn't matter what price you pay…the growth potential is unlimited."* It's easy to look back with 20/20 hindsight and criticize past investor folly, but it's also foolish to dismiss, without consideration, the investment opportunities tied to megatrends. Our profitable-growth framework is well suited to evaluating high growth opportunities and not overpaying for them. Understanding how past disruptions led to investor manias helps us interpret our own environment. Several historical disruptions of note include:

The Canal Mania of the 1790s: In the first industrial revolution, beginning in the 1770s, mechanized factories began to transform the rural English economy. There was a rapid expansion of roads, bridges, ports and canals to support the growing flow of trade. In the 1790s, a Canal Mania emerged, as money flowed in to fund the exciting new technology. The investments funded canal after canal, only some of which were truly needed. The mania continued until the Canal Panic of 1797. There was a lot of waste and pain, but in the end, it funded the infrastructure that remade the English economy.

The Rail Mania of the 1840s: Sparked by the transformational impact on society of rail travel, there was an amazing investment boom in railways. Everyone wanted to invest in this exciting "New Economy." That is, until the Rail Panic of 1847, when investors finally realized that England had built far more railways than were needed. Ultimately though, these rail assets were instrumental in supporting England's phenomenal economic growth. Over time, the overbuilt/underutilized rail network was absorbed by that growth.

The Roaring 1920s: In the early 20th Century, investors went into a frenzy over the prospects of mass production, inspired by Henry Ford and the emerging auto industry. Financial speculation grew rife and by the mid-1920s, the stock market had taken over as the engine moving the US economy. This was an unstoppable bull market, and everyone wanted a piece of it. We all know how that ended for speculators, but the residual benefits to the real economy were spectacular.

The Computer/Internet Revolution: In 1971, the first commercially available microprocessor that could make calculations on a silicon chip was introduced. Recognizable to only a handful, this was "the big bang of a new universe of all-pervasive computing and digital communications." These chips would ultimately transform how most people on the planet work and live their everyday lives. When the Internet appeared in 1994, the effects exploded. The proof that a "New Economy" had arrived was found in the ebullience of the 1990s. Making money became a subject of universal interest as everyone rushed to take advantage of the new investment opportunities. Just like the 1920s, the financial frenzy overtook practicality and it became about making money on money. When these trends proved unsustainable, the dot-com bubble burst in 2000, leaving real-world pain throughout Silicon Valley and beyond. But again, despite the pain and waste caused by the mania, a valuable infrastructure of computers and telecommunications equipment for the economy had been put in place. [5]

<u>Then and Now</u>

With the benefit of history, we have some perspective on understanding today's disruptors. Several recent disruptors have primarily impacted the consumer by changing the planet's social connectivity. A small cadre of semi-oligopolistic companies have generated above average idiosyncratic growth in an era of tepid global economic expansion. The market dominance of these few companies has pushed their revenues, market values, and valuations to unfathomable levels. These have become the consensus "must own" stocks, and this has distorted financial markets. We are not judging investor behavior specifically, but we are interested in how the growing size of these companies, in revenue as well as market cap, affects certain competitive landscapes. Recently, as they have become so large, they are finding growth harder to come by. The only logical response is to poach the lush markets of the other giants, so they have begun competing with each other. Below are some highlights of this clash of the titans:

- Google, with roots in search, is challenging Amazon (AMZN) in cloud storage; AMZN in turn is taking share in search via its voice-activated Echo product
- Netflix, dominant in content streaming, is seeing challenges from Amazon and now from Disney as well
- Apple, innovator within smartphones and creator of the iOS operating system, is in a constant battle with the massive South Korean conglomerate, Samsung; Samsung uses Google's Android operating system; the situation is complicated by Google's entry into the phone hardware market with its own phone, the Pixel, a capable competitor

[5] *Understanding Disruption: Insights From The History of Business*; Steve Denning, Contributor; Forbes Magazine, June 24, 2014

- Google is slowly wrenching away Apple's long dominance in education by offering products at much lower price points; this affordable hardware (Chrome Book) seamlessly integrates with the company's emerging cloud business (Google Drive)
- Microsoft is the dark course in this battle of the titans. Long the butt of jokes among consumer tech users, Microsoft is emerging as a viable competitor with its Surface product. The Windows operating system is evolving to be more appealing to consumers; if it can shrug off its "uncool" image, it could use its existing monopolies to fund its entry into new markets. It has a formidable cloud storage infrastructure, which could drive margins and cash flow; it's entrenched in the business community with its operating system and Office Suite. Its greatest challenge, as we see it, is to prevent Google from solidifying its foothold in the education market, fostering a future generation of working adults who were raised on Google Chrome OS and Google Docs/G Suite rather than Windows/Office

In a world of instant connectivity, social media, and FOMO, the *Network Effect*[6] has never been more influential. Today's dominant companies all have this feature in common, and coupling the Network Effect with high *Switching Costs,*[7]can produce a formidable enterprise. Both the Network Effect and high Switching Costs are attractive elements of competitive advantage, highly sought out by smart companies. Competitive advantages, in turn, are important drivers of return on capital.

The Competitive Advantage Period (CAP)

Value creation is a function of high or increasing returns on capital. When considering returns on capital, both magnitude and duration are important. The greatest value is created at the intersection of highest return and longest duration. A company's competitive advantage bears significantly on this equation. The magnitude of profitability is the spread of its return on invested capital (ROIC) relative to its weighted average cost of capital (WACC); in a nutshell, what it costs a company to get the cash it needs to invest in its business deducted from the returns it earns from putting that cash to work in its business (ROIC – WACC). The wider this spread, the more valuable it is for a company to put capital to work in its business—what we call profitable-growth. Equally important is the length of time the company can maintain that positive spread; because high returns (excess profits) always attract competition, and the ability of an incumbent company to fend off threats is determined by its competitive position, we refer to this time period as the *Competitive Advantage Period or (CAP).*[8] The combined effects of a high (ROIC-WACC) spread and its duration (CAP) are core determinants of intrinsic value. The company-specific factors influencing the CAP include: industry structure, competitive position within that industry, and management strategy. Companies build economic moats to protect excess profits, and this can be costly. Smart managers use the advantage of high profits to keep competitors out. When managers fail to thwart competition they lose their margins and thus the profits needed to defend their moat. Industries with high rates of change (disruption) are more expensive to defend; even companies with seemingly unassailable positions can be threatened, overnight, by an innovative disruptor.

The subtlest changes in strategy can lead to massive value creation even for the largest companies. We discussed capital allocation in a previous Investment Perspectives, but we didn't elaborate on the competitive dynamics under the threat of disruption. Embedded within a company's capital allocation decisions are signals of its management's skill and foresight in generating profitable growth and also in handling competitive threats and disruption. In addition to high profits, companies need access to affordable capital to pay for moat maintenance. Today's digital technology challenges can be met by developing the ability internally or going out and buying it. An example from our own portfolio is Intel's recent purchase of autonomous driving pioneer Mobileye (MBLY). We see this transaction as so transformative that it altered our pending decision to sell the INTC position. Intel was struggling to find profitable growth but this addition of MBLY has meaningful competitive implications for Intel. INTC's stock traded poorly in the aftermath of the transaction, as investors and brokerage analysts did not immediately appreciate the synergies. They questioned INTC's wisdom in paying $15bil for an Israeli company with neither a proven technology nor assurance of future profits. Our analysis stood in sharp contrast, based in large part on our expectations for the future disruptions within mobility. Autonomous driving within a connected car presents massive opportunities for INTC in both its core data management franchise as well as the expected contributions from Mobileye. *[Further details around our analysis of this disruption are included in Part II of this Investment Perspectives].*

[6] The Network Effect is a phenomenon whereby a good product or service becomes more valuable when more people use it.
[7] Switching Costs are the costs that a consumer or business incurs as a result of changing brands, suppliers or products. Although most prevalent switching costs are monetary in nature, there are also psychological, effort- and time-based switching costs.
[8] *Competitive Advantage Period (CAP): The Neglected Value Driver*; Michael J. Mauboussin; Credit Suisse First Boston; January 1997

Traditional technology-focused analysts following INTC were negative on the deal but are slowly coming around. At HCM, we applied our cross-industry knowledge of the automotive sector to find value in the combination. MBLY is an untested technology because it has not yet been designed into the major auto OEM[9] production lines. Our past experience analyzing auto companies gave us an appreciation for what it takes to become an approved supplier to an auto OEM. Automakers do not speculate on unproven technologies supplied by companies whose financial strength may be tenuous. Within weeks of the merger disclosure, several auto companies announced commitments to work with INTC/MBLY.[10] In addition to the great potential we see for autonomous driving, we think there are important network effects associated with getting designed-in early. Having Intel as their parent company increases Mobileye's chances of being accepted by the major automakers. As a side benefit, it was smart and accretive to use $15bil of stranded cash[11] to pay for the transaction.

<u>Today's Disruptors</u>

The Sharing Economy: describes a socio-economic system built around the sharing of human, physical, and intellectual resources. The shared creation, production, distribution, trade, and consumption of goods and services removes the middleman and collectively optimizes underutilized inventory; the most obvious industries affected: hotels, travel; the dominant proponents include Airbnb, Uber, Lyft, Ola, and TaskRabbit.

Autonomous Driving: industries to be impacted – car insurance, aged care, parking, taxis, public transportation, logistics, and delivery/Postal Service; owned autos are expensive and are used on average only 4% of the time.

Internet of things (IoT): essentially it's machine-to-machine communication built on cloud computing and networks of data-gathering sensors; in a few short years, this market will be larger than smartphones, PCs, tablets, connected cars, and wearable devices combined; how to play: data handlers and communication managers (INTC), sensor manufactures.

The Gig Economy: an environment in which temporary employment positions are common and organizations contract with independent workers for short-term engagements; this is changing the workforce; there are estimates that, within five years, 40% of global employees will have non-standard employment contracts. One of our portfolio holdings, Robert Half International (RHI), specializes in helping companies manage employment-related functions.

The magnitude of disruptive forces is often hard to see at its early stages. Disruption can take time – it took years for Netflix to knock Blockbuster Video out of business. Customer behavior had to gradually shift from checking out videotapes on immediate impulse, to waiting several days for a DVD to arrive. Even though they didn't satisfy consumers' impulse needs, DVDs had quality, convenience, and cost advantages. Interestingly, Netflix is in the midst of disrupting its <u>own</u> business – a requirement of successful companies in industries with rapid technological change. Netflix is morphing from a DVD-only company into a hybrid model, offering DVDs by mail as well as streaming content. They face growing competition from other providers of streaming content. Amazon has entered the fray, using its competitive advantage of cloud services to store and stream content, plus its access to cheap capital[12] to finance its own original content; it may even make sense for them to purchase a media company to intensify their access to content. In recent weeks, Disney, long a provider of content to Netflix for streaming, announced that it was pulling all of its content from Netflix as it is starting its own streaming content business. Disney's decision exemplifies the complexity of operating in an industry with rapid change and disruption. Imagine being Netflix management and learning overnight that, not only were you losing a key supplier of your product, but that this former business partner was now becoming a formidable competitor. Netflix must have foreseen this risk, which explains its efforts to develop original content. Only Netflix's vast financial resources allow it to at least attempt to adapt to this emerging competitive threat.

<u>Misconception: *Value Investors Can't do Tech*</u>

Throughout this past decade of low economic growth, we've written a great deal about the market's preference for growth stocks over value stocks, as investors have shown an increasing willingness to pay ever-higher valuation multiples for those companies with unique growth attributes. Despite some obvious differences, the distinction between the growth and value investing styles is not so straightforward. Successful growth investors are able to find companies with high returns and stable or expanding CAP's. As value investors, we find quality companies with CAP's that are compressed for reasons we view as transitory. The market will compress the CAP's of high quality companies when they face adversity. That adversity usually affects a company's ability to grow. Before purchasing a stock, we must see a clear path to recovery, whereby the company can find new avenues of profitable growth. When the competitive challenges are significant and/or disruptive, we must discern whether the franchise value is damaged permanently or only temporarily.

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[9] OEM is Original Equipment Manufacturer, such as Toyota, GM, Ford, BMW, etc.

[10] Nissan, Volkswagen AG, and BMW AG are among the new data partners.

[11] Stranded Cash is money built up from foreign profits but stranded in non-US jurisdictions; under current US corporate tax law it is prohibitively expensive for INTC to bring cash into the US from foreign markets.

[12] AMZN can borrow money more cheaply than the nation of China.

In all cases, a viable investment for us must include restoration of growth.

Our valuation process is comprehensive and rooted in the cash economic frameworks of Economic Profit[13] and Economic Value Added (EVA).[14] Through a proprietary methodology we convert accounting-based financial data into economically-relevant data. This flexible analytical process is not limited by rigid, rules-based methods that exclude companies based purely on high valuation multiples. By looking at a company's "clean" financials in a cash economic framework, we can decide the right price to pay for any level of growth. The ability to analyze companies in this style-agnostic manner means that we can look at a very broad array of companies, irrespective of their growth rates or valuation multiples. Additionally, by calculating the Competitive Advantage Periods, we can compare companies with different valuations, growth, and risk profiles. We view valuation multiples as useful shortcuts, but not every stock with a low valuation multiple represents good value; nor is every company with a high multiple a poor value. A company with relatively slow growth, and high returns, in a stable industry, may warrant a higher valuation than a high growth, high return company in an industry undergoing constant change. Different risk profiles explain part of the difference, and in "normal" markets, investors will account for high disruption risk by paying lower valuation multiples. We are keenly attuned to many of the most innovative technologies and their potentially disruptive influences, but when these cutting-edge companies attract the attention of too many other investors, such popularity generally renders them unsuitable for us. While we do not automatically exclude companies within industries undergoing rapid change or disruption, our unwillingness to overpay for "must own" stocks, means we choose to forego investing in many of the more exotic companies.

Who Will Survive in Retail?

Perhaps the most poignant example of disruption today is the carnage we are witnessing in tradition brick-and-mortar retail. Retail stocks have been decimated by Amazon fears, yet 90% of retail transactions still occur in-store. To the seller it's about increasing efficiency and removing the middleman in each transaction; to the consumer it's about convenience, access to comparison features, and user reviews. The trend toward direct-to-consumer selling has been devastating to those retailers without the ability to offer customers a reason to remain loyal. The long term effects on the companies remain unknown, but the behavior of investors is fascinating. Greed and fear are opposite sides of the same coin, and in the current market environment we've talked a lot about investor greed. But, looking at the stock performance of many retailers, illustrates the fear that disruption can bring out among investors. Even lacking concrete data, just the hint of disruption risk is enough to send investors fleeing to the exits.

- Since January 2016, the retail stocks perceived to be vulnerable to Amazon are, on average, down 20%, while those thought to be immune are up 40%; those vulnerable companies also suffer a 7-turn price-to-earnings multiple discount (15x vs. 22x)!
- The day that Amazon announced the acquisition of Whole Foods Market, the vulnerable stocks declined 1% while the resistant basket rose

It is investor behavior such as this, driven by emotion rather than analysis, which often affords us the opportunity to find value. Some retailers are indeed feeling the pressure from digital competitors, but not all, and certainly not equally. Recent trends do not look promising for traditional retailers, and if we were to extrapolate these data out into the future, we might conclude that nearly all future sales would occur remotely. To extrapolate this way is a normal human behavior, but not one conducive to successful investment decision-making. This behavior is so common that academics have coined the term, *Recency Bias*[15] to describe it. We are not dismissive of the disruptive effects of digital commerce, but we can draw no long term conclusions based on currently available information. This does not mean that we ignore the risks and remain inactive. We pay close attention to management's response to competitive threats and disruption. One of our former holdings, Kohl's Corp. (KSS), was unwilling or unable to develop a strategy to cope with ongoing threats. The company continued to generate strong cash flows, but rather than deploying those cash flows toward developing a new strategy, they just continued to buy back stock. Absent any positive value creation through profitable growth initiatives, and no visible strategy for change, we exited the position. Williams-Sonoma (WSM), on the other hand, has been extremely proactive in adapting to these challenges. They are investing in their business lines that are growing rapidly while generating high returns on invested capital. Despite already having beautiful stores, they sell 52% of merchandise on-line, and are spending capital on modifying their stores to showcase merchandise that can be bought in-store or on-line. In response to customer complaints about delivery issues, they modified their entire supply chain and logistics systems to satisfy their on-line customers and bolster their competitive position. Management is adjusting to these

[13] Economic Profit is the amount of income left once the cost of capital (or investors' expected return) has been accounted for.
[14] Economic Value Added (EVA) is Net Operating Profits after Tax (NOPAT) minus a capital rent (Invested Capital (x) Cost of Capital).
[15] Recency Bias is the human mind's inclination to use our most recent experiences as the baseline for what will happen in the future.

changes by using data analytics; the company has decades of customer data which they are using to shape strategy. Another of our portfolio holdings, mall operator, Simon Property Group, is adapting to change its own unique way. Exploring a concept called "Bundling Mobility," Simon is considering ways to use cheap mobility to drive mall traffic. One idea includes offering to send a vehicle to pick up shoppers at their homes, bring them to a Simon mall and then take them home after they finish their shopping. It is this type of creativity, initiative, and forward-thinking strategy that will differentiate the winners from the losers.

Conclusion

We see the effects of disruption all around us, in our investments and in our daily lives. To many, this explosion of innovation and digital transformation looks like a never before seen phenomenon, but technological disruptions are not new to the 21st century. To every generation that has experienced them, these waves of change bring visions of endless prosperity. While it's true that some disruptions have left lasting effects that have improved the human condition, they also nearly always resulted in financial frenzies that devastated investors. Disruptions can create investment opportunities, but successful investors are those who suppress Recency Bias, FOMO, and greed to avoid the most obvious and over-crowded ideas. Not going along with the crowd can be very difficult, particularly when there's a near-universal conviction that an investment is a "no-brainer." The most obvious investments are almost always the most dangerous though. We are aware of these behavioral biases and our disciplined methodology keeps us grounded.

The competitive analysis framework within our investment process accounts for changes in the competitive landscape, including disruption risk. We hold management accountable for their ability to adapt to change; when they do not make decisions that add value, we move on.

- When incumbent companies ignore competitive threats and allow new competitors to gain a toehold, they may find themselves scrambling to retake their markets; this is made more difficult when industries have network effects or high switching costs
  - Companies may have to spend/invest aggressively in order to retain customers or defend market share
  - We hold management accountable for this spending to ensure that it is money well spent
  - Changes in return on invested capital measure the success or failure to adapt
- When one of our companies is an industry leader, we pay close attention to management's efforts at staving off threats from disruptive influences at the edges of their business
  - We glean signals of management's strategic vision from the qualitative aspects of capital allocation policy

Disruptive innovation is not new, but as investors, we have to separate the exciting aspects of the improved human condition from the investment merits of the companies propagating and benefiting from the change. A successful investor discerns this difference by taking a long-term view and applying a multidisciplinary approach in seeing the patterns over history. The relatively productive bubbles (canals, rail, mass production, and computers) were bursts of creativity that, at the time were disruptions, but eventually grew into valuable innovations with massive profit potential. When expectations grow to a frenzy, it leads to financial speculation and misallocation of capital. What was once an avant-garde vision becomes conventional wisdom and a consensus view that the extraordinary returns of the hyped "New Economy" will continue in perpetuity. When we look at very long time periods, we can evaluate the choices made in the past and, in them, see patterns. Not all of these choices were productive, but only by looking at the past can we evaluate our own options that lie ahead.[16]

[16] *Technological Revolutions and Financial Capital: The Dynamics of Bubbles and Golden Ages*; Carlota Perez.

PLEASE SEE IMPORTANT DISCLOSURES BELOW:
As of September 30, 2017, Hutchinson Capital Management (HCM) held:

140 shares of ALPHABET INC CAP STK CL A (GOOGL)
10 shares of ALPHABET INC CAP STK CL C (GOOG)
60 shares of AMAZON.COM INC. (AMZN)
8,455 shares of APPLE COMPUTER INC (AAPL)
12,717 shares of BANK OF NEW YORK (BK)
5 shares of BMW-BAYERISCHE MOTOREN WERKE A G (BMWYY)
2,005 shares of FORD MOTOR COMPANY (F)
551,154 shares of INTEL CORPORATION (INTC)
336,743 shares of JACOBS ENGINEERING (JEC)
896 shares of KOHL'S CORPORATION (KSS)
170,874shares of MICROSOFT CORPORATION (MSFT)
762,357 shares of MOSAIC CO NEW COM (MOS)
655,544 shares of NOW INC. (DNOW)
464,837 shares of ROBERT HALF INTERNATIONAL INC (RHI)
56,771 shares of SIMON PPTY GROUP INC NEW COM (SPG)
88,122 shares of TOYOTA MOTOR CORP SP ADR REP2COM (TM)
507 shares of WALT DISNEY COMPANY (DIS)
355,694 shares of WILLIAMS-SONOMA INC (WSM)
0 shares of GENERAL MOTORS COMPANY (GM)
0 shares of MOBILEYE (MBLY)
0 shares of NETFLIX, INC. (NFLX)
0 shares of NISSAN MOTOR CO. (NSANY)
0 shares of VOLKSWAGEN AG (VLKAY)

As of September 30, 2017

ALPHABET INC CAP STK CL A (GOOGL) closed @ 973.72
ALPHABET INC CAP STK CL C (GOOG) closed @ 959.11
AMAZON.COM INC. (AMZN) closed @ 961.35
APPLE COMPUTER INC (AAPL) closed @ 154.12
BANK OF NEW YORK (BK) closed @ 53.02
BMW-BAYERISCHE MOTOREN WERKE A G (BMWYY) closed @ 33.842
FORD MOTOR COMPANY (F) closed @ 11.97
INTEL CORPORATION (INTC) closed @ 38.08
JACOBS ENGINEERING (JEC) closed @ 58.27
KOHL'S CORPORATION (KSS) closed @ 45.65
MICROSOFT CORPORATION (MSFT) closed @ 74.49
MOSAIC CO NEW COM (MOS) closed @ 21.59
NOW INC. (DNOW) closed @ 13.81
ROBERT HALF INTERNATIONAL INC (RHI) closed @ 50.34
SIMON PPTY GROUP INC NEW COM (SPG) closed @ 161.01
TOYOTA MOTOR CORP SP ADR REP2COM (TM) closed @ 119.17
WALT DISNEY COMPANY (DIS) closed @ 98.57
WILLIAMS-SONOMA INC (WSM) closed @ 49.86
GENERAL MOTORS COMPANY (GM) closed @ 40.38
MOBILEYE (MBLY) closed @ 62.67
NETFLIX, INC. (NFLX) closed @ 181.35
NISSAN MOTOR CO. (NSANY) closed @ 19.49
VOLKSWAGEN AG (VLKAY) closed @ 33.81

As of September 30, 2017, the following were the ten largest holdings of HCM:

Name of Issuer	% of Equity Portfolio	9/30/2017 Closing Price
NOVO-NORDISK A S ADR	6.5%	48.15
ROBERT HALF INTERNATIONAL INC	6.2%	50.34
CARNIVAL CORPORATION	6.0%	64.57
INTEL CORPORATION	5.6%	38.08
WELLS FARGO & CO	5.5%	55.15
NATIONAL OIL WELL VARCO	5.3%	35.73
JACOBS ENGINEERING	5.2%	58.27
MARKEL CORP COM	4.9%	1067.98
JOHNSON CONTROLS INC	4.7%	40.29
WILLIAMS-SONOMA INC	4.7%	49.86

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.

Nothing herein should be construed as a solicitation or offer, or recommendation to buy or sell any security, or as an offer to provide advisory services in any jurisdiction in which such solicitation or offer would be unlawful under the securities laws of such jurisdiction. The material provided herein is for informational purposes only. Before engaging HCM, prospective clients are strongly urged to perform additional due diligence, to ask additional questions of HCM as they deem appropriate, and to discuss any prospective investment with their legal and tax advisers.