Hutchinson
CAPITAL MANAGEMENT

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INVESTMENT PERSPECTIVES

Disciplined Investing Can be Unfashionable

It's halftime for 2019, and we want to provide a progress report on the markets and our portfolio results. Even though we have grown your wealth through this period, the investment climate in recent years has been extremely challenging for us and for many value-oriented, fundamental investors. In this Investment Perspectives, we want to share our thoughts on the markets, where we see the most significant risks, and the methods we employ to navigate them. The impetus behind the piece is our belief in the merits of increasing transparency and communication during challenging periods. Our patience and discipline as investors do little good if our clients don't share our confidence and optimism. Communicating openly is more difficult when recent outcomes have been below our expectations, but we are not the sort to dodge accountability. We can only expect you to remain patient and trust that we are doing the right things if you have clear insight into why we make the choices that we make. We face a market environment similar to the late-1990s when value investing was deeply out of style for an extended period, and its practitioners pilloried as 'out of touch.' Naturally, this was wrong. What's less obvious is, the reason value investing ultimately prevails, owes to the difficulty in remaining disciplined through stressful market cycles. In investing, as in life, reward comes to those thoughtful, diligent individuals with the fortitude and patience to work through adversity.

"*To make money in stocks you must have the vision to find them, the courage to buy them, and the patience to hold them.*"[1] Patience is the most challenging of the three; sometimes the hardest thing to do is to sit still. Patience is an acquired skill, fed by experience and reliant upon conviction in the investment process and sound risk management policies. Having many years of investment experience means we have been through several market cycles and have seen our investment process put to the test and prove durable. Value has been out of favor for so long that it's easy to understand the feelings of despair among value investors. Despite the longevity of this cycle, we're still only in the front-end of it—meaning the lack of investment opportunities continues to hamper returns.

What's Working and What's Not

The most influential market factor driving favorable returns in stocks over the past several years has been Price Momentum. The two worst-performing factors have been Value and Small Market Capitalization. We do not intentionally look for small-cap stocks, but many of our portfolio holdings became attractive value opportunities because their stock prices (and market caps) declined significantly. Since this contrarian strategy is the opposite of price momentum (the dominant factor in recent years), we know we will suffer poor relative returns until something changes: as more of our portfolio holdings are recognized by the market for improving fundamentals, we can begin to outperform in a flat or rising market; or the market enters a prolonged downturn and there's a regime shift in factor preferences away from mega-cap growth toward fundamental value.

The companies exhibiting attractive value properties have been those with businesses tied to the real economy and/or commodities. While our confidence in Energy, Materials, and cyclicals[2] remains strong and sound, we can't have a portfolio dominated by the same economic sensitivities. In addition, even though it is not as predictable as a Newtonian law governing the physical world, the mean reversion law always works in the realm of investing. It works because the principal reason stock prices get out of alignment with company fundamentals is investor emotion and extreme swings in human emotions **always** reverse.

The timing of the eventual change in market conditions that brings about mean reversion is uncertain. Like making a diamond, the right environment for value investing requires both pressure and time. The downturn in markets in

[1] Phelps, Thomas; "*100 to 1 in the Stock Market*"; Echo Point Books & Media; January 1, 2015.

[2] Cyclical companies are those with businesses which are more heavily dependent upon strength in the overall economy. Examples include: manufacturing, steel, travel, and construction.

December 2018 was sharp, but it was merely an air pocket, not an end to this long cycle and no gems were made. In fact, that sell-off hurt us disproportionately because it reinforced the existing momentum trend in the market. During a sell-off in a market environment deaf to fundamentals, investors sell even more of what hasn't been working regardless of how cheap it is.

Simple but Not Easy

Albert Einstein said, "*Everything should be as simple as it can be, but not simple*r." Finding the right balance between risk and return is such a task. One challenge is that return is visible in real-time, but risk is only evident after the fact—when it's too late. We must be willing to trade some return in exchange for discipline and risk management. As our clients, your statements can only show you half of the equation, so we want to shed some light on the less visible measures we take to mitigate future downside risk and prepare for a more favorable point in the cycle.

At the later stages of bull markets, the siren song of the obvious becomes most seductive. No one rings a bell telling you it's time to run away, but there are definite signs. Beware when you start hearing people say how easy it is to make money in the markets. There are always funny stories in the media about dart-throwers that can pick stocks which outperform professional investors. And perhaps worst of all are the pangs of jealousy and bitterness when cocktail chatter reveals how everyone else seems to be minting money in the most exciting stocks with the raciest stories. While purely anecdotal, these signs always coincide with a diminished opportunity set of suitable value investments. We have purchased six stocks, year-to-date, but our research team has analyzed 27 other companies that we were forced to pass up. Some of these are terrific companies that we hope to be able to buy at some point, but that are too expensive for us right now. Some of these companies end up on our 'Watchlist,' which details stocks we'd own and the prices that work for us. In this way, we have a built-in opportunity set of ideas that we can capitalize upon under the right market conditions. As the market grows more expensive, so too grows our Watchlist. To be in a position to capitalize on these opportunities, we must hold back sufficient cash to execute these future trades—as the market is bottoming out, we shouldn't have to sell our own stocks at depressed valuations in order to raise the cash to buy cheaper stocks. Fortunately, our portfolio management process is designed to make this happen naturally. However, this only works if we remain disciplined, harvest profits and allow our cash position to build as the bull market matures. If we lose our discipline, succumb to pressure, and buy overvalued stocks, we intensify our exposure to downside market risk, while also depleting the dry powder we need to buy our Watchlist stocks. Sounds simple, right? But there's a catch. In a raging bull market, holding cash is expensive. Every dollar we hold back in reserve has a short-term opportunity cost. While we earn a modest 1%-2% deposit rate on that cash, speculators and dart throwers outpace us, as they easily generate double-digit returns using darts to pick stocks. We avoid cocktail parties at this point in the cycle.

Returns on different assets vary and, over time, the relative weights of these assets change. When this happens, an investor can either allow the portfolio to drift or make adjustments to realign the exposures to the intended levels. A drifting portfolio sees the weight of outperforming assets rise, and the allocation to underperforming assets shrink. These shifting weights have both performance and risk implications. This occurs at both the individual security level and the asset level (i.e., equity, bonds, and cash). When changing asset prices alter the portfolio risk profile, we make adjustments. Our rebalancing approach is active, flexible, and adaptive by incorporating expected market conditions into our investment process. In this way, we evaluate the prospects for future returns and the risk we should take to achieve them. At the individual stock level, we employ proprietary intrinsic value calculations and ratio measures like price-to-earnings and price-to-book value to adjust position sizes.

Over the long term, a sound rebalancing strategy can both reduce risk and enhance returns. This works largely because it is contrarian in nature and benefits from two factors: (1) The Value Premium and (2) The Small Cap Factor. Interestingly, these two most durable factors driving long-term outperformance have been, consistently and persistently, the worst factors throughout this extended cycle. We have discussed many times over the past several years that intervention by central banks has distorted the market pricing mechanism. It could be that these market distortions have prolonged the inhospitable environment for value investing, but the jury is still out. Despite the current challenges, decades of experience reinforce our confidence and support our ability to be patient.

Rebalancing instills another layer of discipline which prompts us to reduce assets that have appreciated while adding to those which are temporarily out of favor. During bull markets, particularly long-running trending markets or periods of speculative excess, a rebalancing discipline will hamper returns relative to capitalization-weighted benchmarks. Done prudently, and intelligently, rebalancing offers risk reduction with an acceptable sacrifice of relative performance during upward-trending markets.

Spotting the Bubble

Past cycles offered clear paths of bubble-avoidance, but this cycle is uniquely challenging. Long-term clients of HCM have benefitted from our process of shunning the most crowded and expensive areas of the market. This was only apparent following the conclusion of the entire market cycle. Those who have become clients later in this current cycle have only seen us grapple with frustrating conditions. It requires a full market cycle for an investment strategy like ours to bear fruit. We advocate patience but will continue being transparent so that you have clear sight into our investment strategy.

We can only identify a bubble for sure after it pops, but we garner hints from an asset's popularity among investors. Looked at through such a lens today, points to capitalization-weighted indexes as the most likely suspect. This is a sly, pernicious risk because of the way most investor funds are managed. If the most crowded asset is the benchmark against which most professional investors are measured, it intensifies the pressure on fund managers to take more risk. The larger the bubble inflates, the greater the pressure on fund managers to abandon a lagging investment process to jump on the conformance train. Rest assured, we have no plans of joining this performance derby. We've seen this play before, and we know how it ends.

Index investing was popular in the late-1990s too. A similar attitude of ease, coupled with a disregard of fundamentals was pervasive. Those investors piling into capitalization-weighted indexes paid a heavy price for their complacency. The S&P index construction team concentrates their purchases on the top-10 companies by market capitalization and to traffic in such products profitably requires impeccable timing skills. Failure to find a 'greater fool'[3] to pay a higher price near the top of the cycle means potentially sharp losses. Equally difficult is having the courage required to step back into stocks after painful losses.

Microsoft was the only top-10 tech stock at yearend 1999 to beat the S&P 500 Index over the next 19 years.

Top 10 Tech Companies in 2000 by Market Cap

Name	Market Cap (Jan 1, 2000, $ Million)	Rank in Year 2000	Annualized Return (Jan 2000–Dec 2018*)	Annualized Return (Jan 2000–May 2019*)	Ending Value of $100 (Jan 2000–May 2019*)
Microsoft	$602,433	1	5.3%	6.4%	$334.45
Cisco Systems	$350,424	2	0.0%	1.1%	$123.43
Intel	$275,006	3	2.9%	2.6%	$165.32
International Business Machines	$194,456	4	2.2%	2.8%	$171.04
America Online/Time Warner	$169,618	5	-2.1%	-1.8%	$70.96
Oracle	$159,540	6	3.2%	3.8%	$206.17
Dell Computer	$130,823	7	-8.8%	-8.8%	$28.15
Sun Microsystems	$120,888	8	-24.2%	-24.2%	$6.14
Qualcomm	$115,939	9	-0.7%	0.2%	$104.28
Hewlett Packard	$115,911	10	1.3%	0.4%	$108.75
S&P 500			4.9%	5.3%	$273.23
Average Performance			-1.5%	-1.1%	$144.72
Just the Positive Returns			2.8%	2.8%	$185.83
Just the Negative Returns			-8.9%	-11.6%	$35.08

* Annualized return until delisting (Sun Microsystems in Jan 2010 and Dell Computer in Oct 2013).

Source: Research Affiliates, LLC, based on data from CRSP and Bloomberg.

The indexes buy the most popular, highest market cap stocks while shunning the worst performing. But looking at the rolling 10-year history of the MSCI All Country World Index composition (1980-2018) shows that,

- On average, only 3 of the stocks in the top 10 largest market cap bucket remained in the top 10 a decade later
- After falling out of the top 10 list, these 7 dropouts underperform significantly over the next 10 years
- In the decade after becoming the largest stock in the index, that stock outperforms its index only 5% of the time

This performance chasing is not isolated to the single largest stock. Looking at the S&P 500 and comparing the performance gap between the stocks being added to the index vs. the discretionary deletions, shows a 64% differential. Said another way,

[3] The Greater Fool Theory says that an investor can make money buying stocks regardless of their valuation, by selling them at a profit later, so long as someone else (i.e. a greater fool), is willing to pay a higher price.

- During the 12 months before being added to the S&P 500 index, the average stock had outperformed the index by 36%, while the average company dropped by the S&P had underperformed by 28%
- In the year **following** these adds/deletes, the new index members underperformed by 1.28%, while the deleted stocks outperformed by 19.2%!

This is nothing more complicated than mean reversion and the Value Effect in motion. Based on five separate value metrics, the stocks added were 75% more expensive than the market, and the deleted stocks were 50% cheaper [See Table].[4]

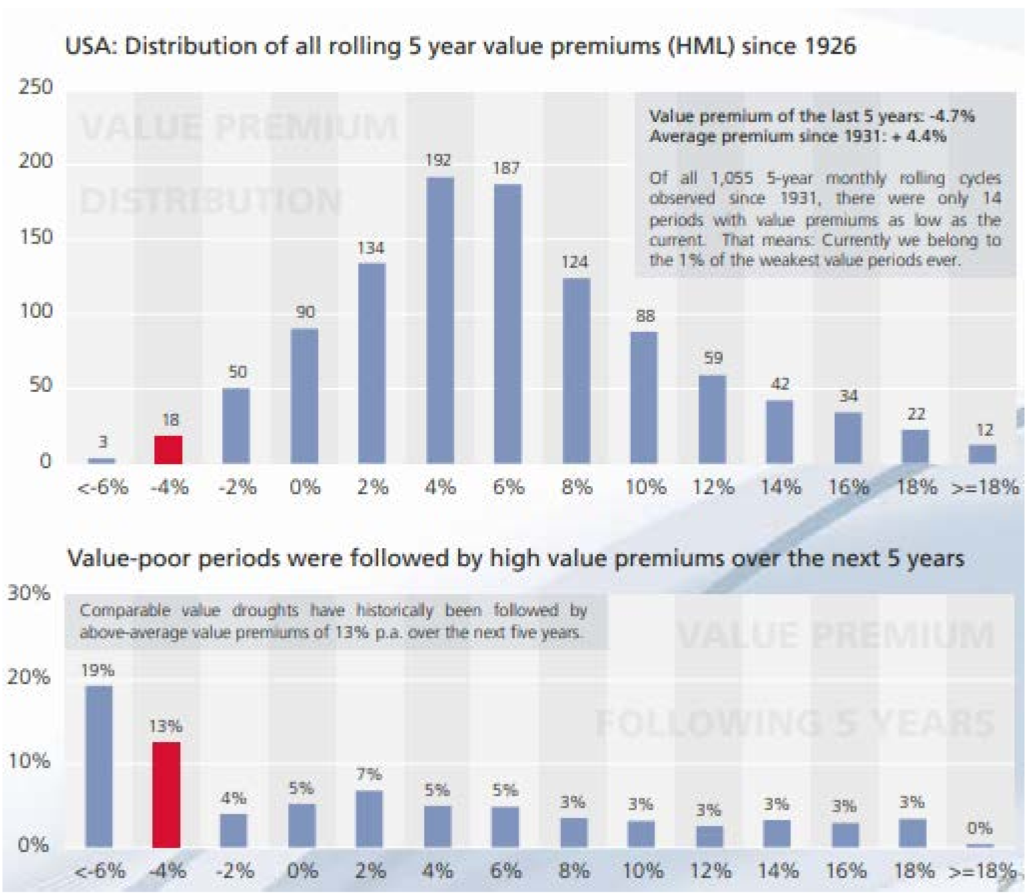
The cap-weighted index rebalancing process is precisely the opposite of our methodology. Such index funds must buy high and sell low. In this way, index funds' largest positions generally trade at premium valuation multiples relative to the average stock in the index.

- Going back to 1989, when we compare the stocks added to cap-weighted indexes vs. those dropped, the new additions have traded at 3.0x the valuation[5], and subsequently underperformed the deletions by 2,200bps over the next 12 months

Similar valuation principles used in individual stock selection can be utilized to evaluate the relative valuation of investment styles like Value vs. Growth. Investment styles rotate in and out of favor for a variety of reasons, and it's insightful to monitor their relative values. Current valuation is the dominant factor governing future returns. In the table below, we highlight the most extreme periods of relative value dispersion between growth/momentum and value. Also included is the relative stock price performance in the three years following the start of the mean reversion process.

	July 2000	January 2006	March 2009	June 2019
Growth/Value Relative Price/Book	14.65x	4.36x	11.50x	20.0x
Value Outperformance Next 3 Years	+60.3%	+33.1%	+44.4%	?

Source: Research Affiliates Smart Beta Interactive Website



The chart below shows just how long we have been grappling with this adverse environment. Not only has Value underperformed with equal severity with previously bad periods, but the two episodes of positive relative returns were far shallower and much shorter.

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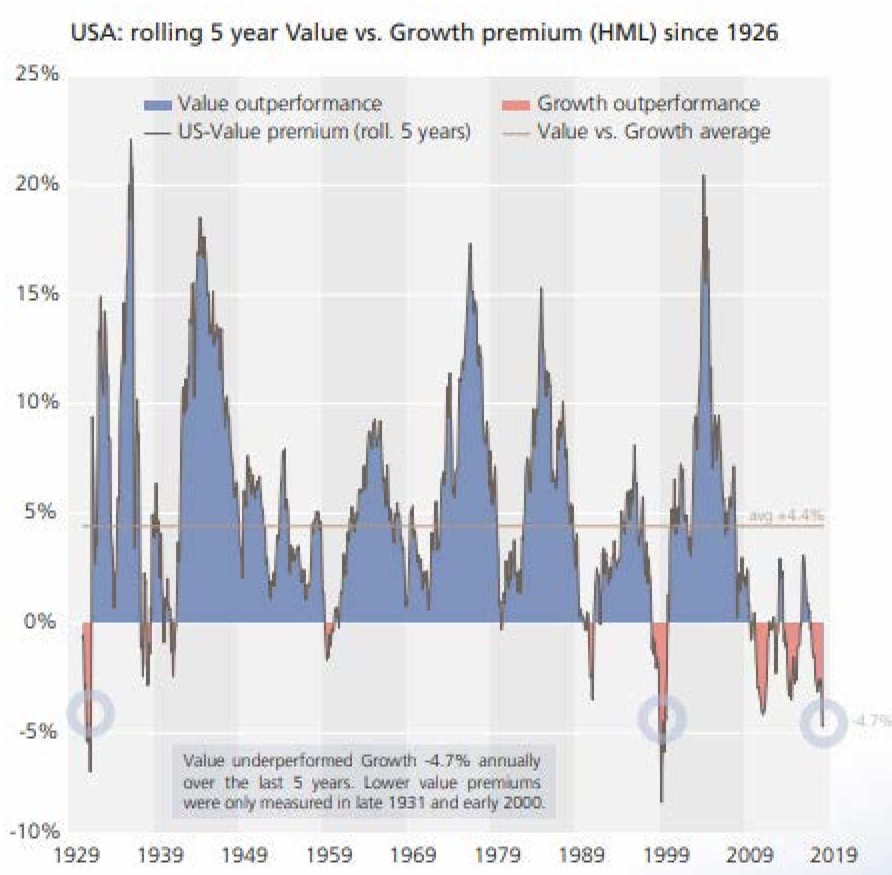
[4] Arnott, Rob; Kalesnik, Vitali; Wu, Lillian; "*Buy High and Sell Low with Index Funds!*"; Research Affiliates; June 2018.

[5] Ibid. The metrics used included: Price/EPS, Price/Cash Flow, Price/Book Value, Price/Sales, and Price/Dividends.



Source: StarCapital, AG; Research in Charts; June 2019 data; https://www.starcapital.de/en/research/update/

Conclusion

The largest source of frustration for us in recent years stems from looking up at the scoreboard every quarter to find that the leaders continue to employ strategies that utilize price momentum at the expense of more contrarian, fundamental value-based strategies. The tools we use to reduce risk, such as rebalancing, can hamper relative returns during certain rally-phases of the market cycle. Relative underperformance can be magnified during long stretches of substantial index price gains when those gains are driven by momentum.

The stocks we've purchased in recent years have become attractive to us because they lacked the sort of price behavior that gets them invited to the ball by Mr. Momentum. Since the momentum factor is still firmly in control of the indexes, many stocks in our portfolio remain wallflowers.

Only a deeply-held conviction in one's investment process, coupled with the patience of the managers and their clients to stay the course, will keep investors from the severe discomfort that will be experienced in the back half of this cycle. Remember, our employees' retirement funds are invested alongside the assets you have entrusted with us—we're in this together.

As always, we seek to preserve capital and maintain purchasing power. This means delivering portfolio returns that grow assets faster than inflation and maintaining a portfolio of stocks that generate competitive returns over an entire market cycle. Remaining patient and disciplined through an entire market cycle can be challenging when your investment style is out of synch with what's been working. The longer this adverse period persists, the more intense grows the pressure to conform, and the added need for patience.

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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