Hutchinson
CAPITAL MANAGEMENT

April 2020

INVESTMENT PERSPECTIVES

A Tale of Two Emotions

> *"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us…"*[1]

Steep market declines are usually cheered by Value investors given the broadening array of attractive investment opportunities. Ultimately, our portfolio will benefit, but we are not cheering the cause. Health risks weigh on the human brain differently than financial risks, and in our current situation, we have both. These concerns, coupled with the logistical challenges of working remotely, have required us to be at our best, and everyone at HCM is rising to the challenge. Investing is an objective, practical, and analytical endeavor, requiring us to filter out the emotional factors and stay focused. So please pardon us in advance if our emphasis throughout this paper centers on how we are positioning the portfolio to benefit from market disruption -- know that we do so with objectivity and not callousness. We are managing through market behavior that investors have not seen in 90 years. This *Investment Perspectives* focuses on the significant issues that present us with an unprecedented investment landscape.

The definition of a '*Bear Market*' is a 20% decline in price from an asset's previous peak. For US equity markets, between 1928 and December 2019, there have been 12 bear markets. These periods have typically lasted around 22 months, ultimately dragging prices down an average of 42%. Human beings think in relative terms so most of us look for parallels to past events in order to formulate strategies to manage current uncertainties. There are aspects of this current situation that resemble previous episodes, but as it evolves, we find ourselves confronted with the word "*unprecedented*" more often than we like.

- The 2020 bear market was the fastest market decline since 1929, falling 34% over 27 trading days before bouncing 17.5% over 3 days
- In 1929, the next most rapid descent, the market fell 39.6% in 40 days before rebounding 19% in 2 days; it subsequently fell another 27.4% in 7 days

We believe that the speed of the decline this year had a lot to do with technical market factors. Unprecedented economic risks cascaded into financial markets with inadequate trading liquidity. Compounding this unstable liquidity condition is the large number of computer-driven investment strategies running through the stock market today.

Today we face uncertainty with a broader range of outcomes than we've confronted in our investing careers. This explains the severe spike in market volatility. When faced with major disruptions, we go back to basics and affirm our investment thesis and intrinsic value[2] assumptions for each of our companies. When the future is cloudy, the market tightens its outlook horizon, becoming more myopic. In our current situation, the available data are very negative and stock prices responded to that. Know our companies exceptionally well enables us to spot opportunities where the market price has discounted more risk than we think is likely.

[1] Dickens, Charles; A Tale of Two Cities; 1859, Chapman & Hall, London
[2] Intrinsic Value is our measure of the total economic value of the company. There are several ways to express it, but in its most basic form it captures the sum of all future free cash flows discounted back at the firm's cost of capital.

Asset price volatility will remain elevated as we work through the current crisis and will diminish only gradually as the path to recovery becomes clearer. Until the fog clears, investors will latch on to close-in data rather than looking out to the future. We believe the shape of the recovery depends on a few key drivers:

1. Trends in controlling the spread of COVID-19; we do not have any unique skill or insight in evaluating this factor, so we must rely on the scientific community
2. The direction and slope of corporate earnings growth
3. Signs that economic data is recovering from social distancing

Stick to the Basic Principles

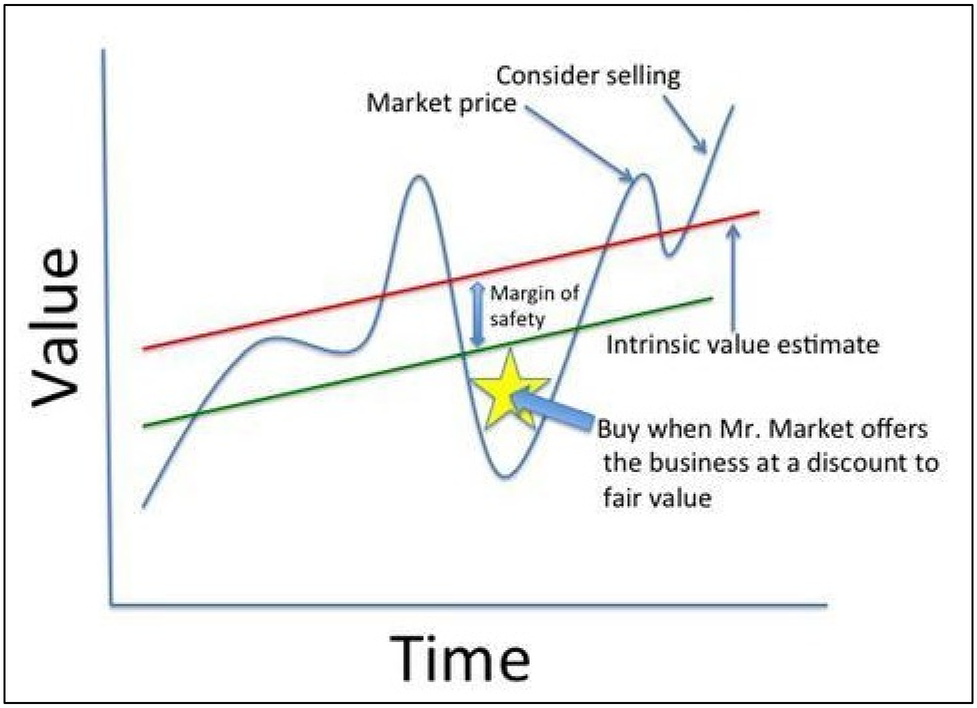
Fear and uncertainty can drive investors to make decisions that are skewed by those emotions. Satisfying the emotion to flee and hide in the stability of cash is a temporary salve but is financially regrettable over the long-run. In such times, it's useful to fall back on your basic investment principles. Some of our core principles are reinforced consistently in our writings, while others tend to reside in the background. When markets become erratic, it's an excellent time to get back to basics and review the core investment principles.

Buy Quality: High-quality companies can weather bad times and recover regardless of how much their prices may decline in the short-run. This means we avoid companies with unmanageable debt levels. One difference we face in this current economic environment is the revenue collapse resulting from social distancing mandates. Manageable debt loads can quickly become burdensome when a business's operations come to a complete stop. Under even the most bearish modeling assumptions for our companies, near-zero revenue is not a scenario for which we account.

Maintain Discipline: Investing discipline involves both buying and selling of securities. We apply rules that blend our risk management policies with our return objectives. The goal is to remove emotion and to accept risks that are aligned with our return expectations. Our rigorous research process means we always know what we own. Our *Buy Quality* principle folds into this investment discipline. In addition to leverage rules, we also require that each security has sufficient trading liquidity. We avoid illiquid securities because assets that are difficult to buy in calm markets can become nearly impossible to sell when markets are distressed. Liquidity is like oxygen – you don't notice it until it's gone. Much more challenging than the purchase discipline is selling. Selling when we're wrong is straightforward – we're not overly stubborn and we don't have egos about stocks. Reducing a stock position when it's performing well is trickier. As stock prices approach our intrinsic value, we may trim or sell. We avoid letting any individual position grow too large relative to the rest of the portfolio. A sound sell discipline will build up cash at points in the market cycle when value is hard to find. A disciplined investment process lowers risk at peak valuations and provides buying power to take advantage of opportunities like the current market dislocation.

The Portfolio is Worth More than the Sum of its Parts: It's easy to become concerned when account balances decline meaningfully from its peak levels. Risks to long-term returns can emerge when the portfolio value at any individual point in time influences behavior. There are several behavioral biases that arise when fear or greed creep in and upset a carefully crafted investment policy. Each position is thoughtfully selected and considered in the context of its effect on the overall portfolio; individual positions are sized based on their risk, correlation, and factor sensitivities. We do not fixate on individual asset's price volatility.

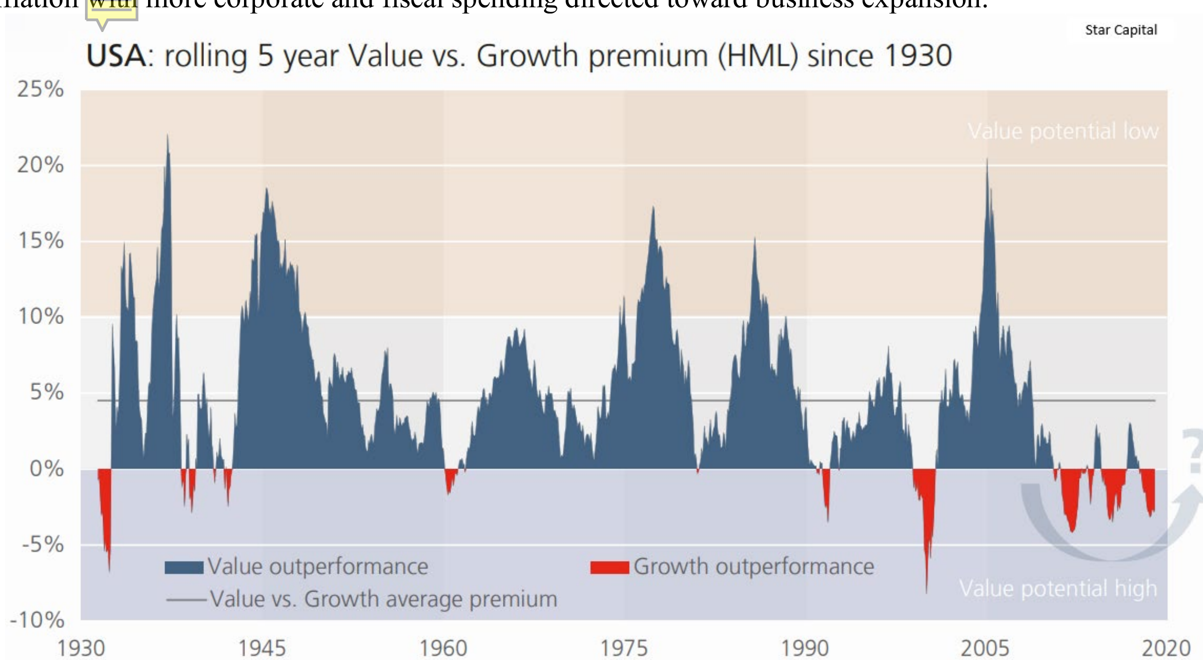
Market Price is Not Intrinsic Value: One trade-off for having ready liquidity is that we must endure the occasional irrational price behavior of public markets. We have no complaints about the pricing mechanism – most of the time. In those brief instances where emotion overwhelms fundamentals, we get price dislocations. These occur both above and below the intrinsic value line. We make occasional mistakes in our research process, and when that happens, we exit, take our lumps, and move on. What we do not allow is for the price volatility to influence our decision-making process. Just because a stock price declines does not mean our investment thesis is wrong. There's a saying among investors, "*Nothing changes sentiment like price*." But price volatility is not value destruction until you allow it to influence your investment process and sell in fear. As a general rule, market prices are far more volatile than intrinsic value.



Source: Investopedia

We don't have any keener insight into the shape of the recovery, and with the wide dispersion in potential outcomes, we have made only gradual, incremental adjustments to the portfolio. The conditions under which investors are forced to sell for non-fundamental reasons don't come around very often, so when they do, it's essential to be prepared to capitalize on it. We fully expect that we will not catch the bottom in stock prices, but we are confident that three to five years from now, the prices we are paying for high-quality businesses today will look like bargains.

Market transitions are unsettling, but out of the pain comes renewal. We are hopeful that after 12 long years of underperformance relative to Growth, our Value-oriented investment style will return to favor. Buying value seems logical to us, and Value outperformance has been the normal condition for US equities. The post-Great Financial Crisis (GFC) period has been anything but ordinary, and this stretch of Value disadvantage is the longest-ever by a factor of two. It coincided with the below-trend economic recovery. Value strategies tend to struggle during periods of low inflation and declining interest rates. There's a sound case to be made that, following the COVID-led recession, we enter a period of higher inflation with more corporate and fiscal spending directed toward business expansion.

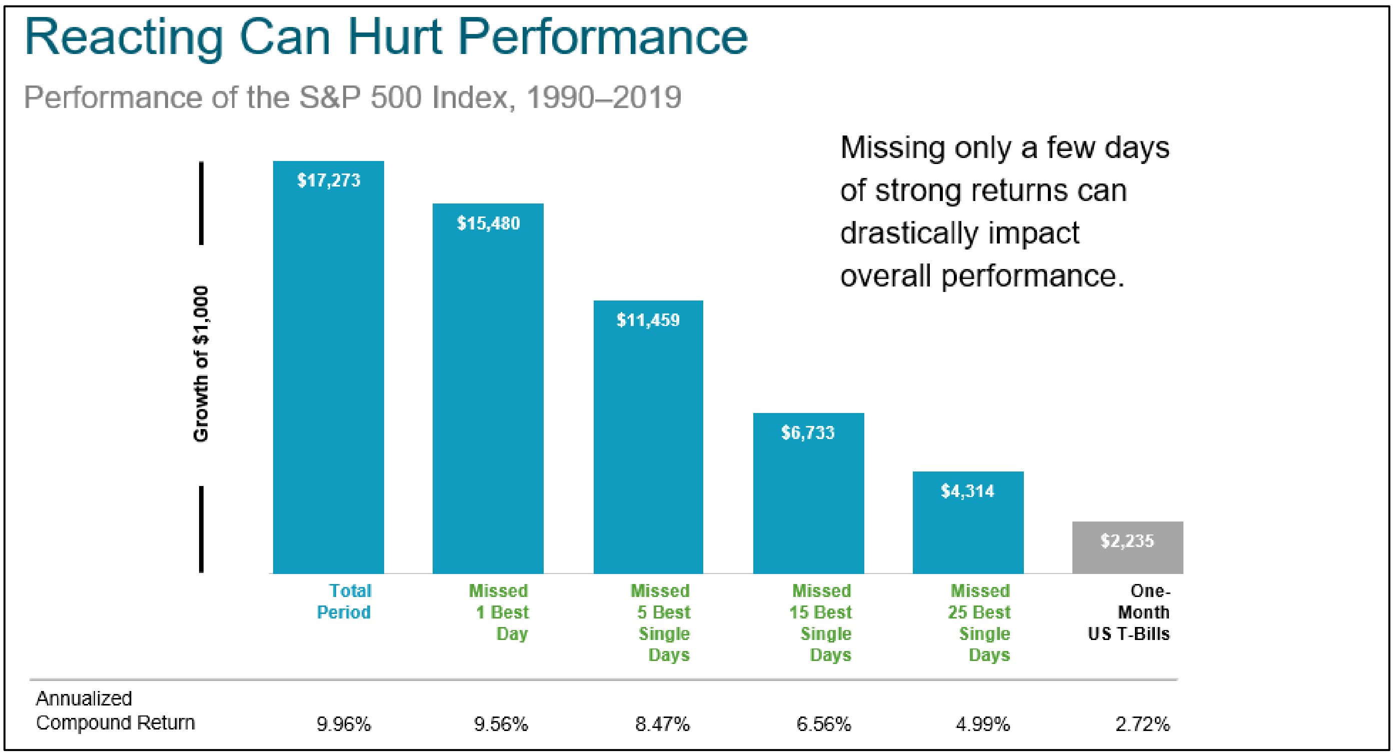


Planning for the Recovery

It takes conviction to step into a market and buy when most around you are selling, but that confidence is necessary to employ an active rebalancing strategy. The ability to lower the cost basis by averaging down makes it easier to recover from drawdowns. Remember, when looking simply at percentage changes, a portfolio that declines by 25% and then recovers by 25%, is not back to break-even. Having suitable cash going into a downturn lessens the emotional strain of the price declines while also providing the fuel for rebalancing.

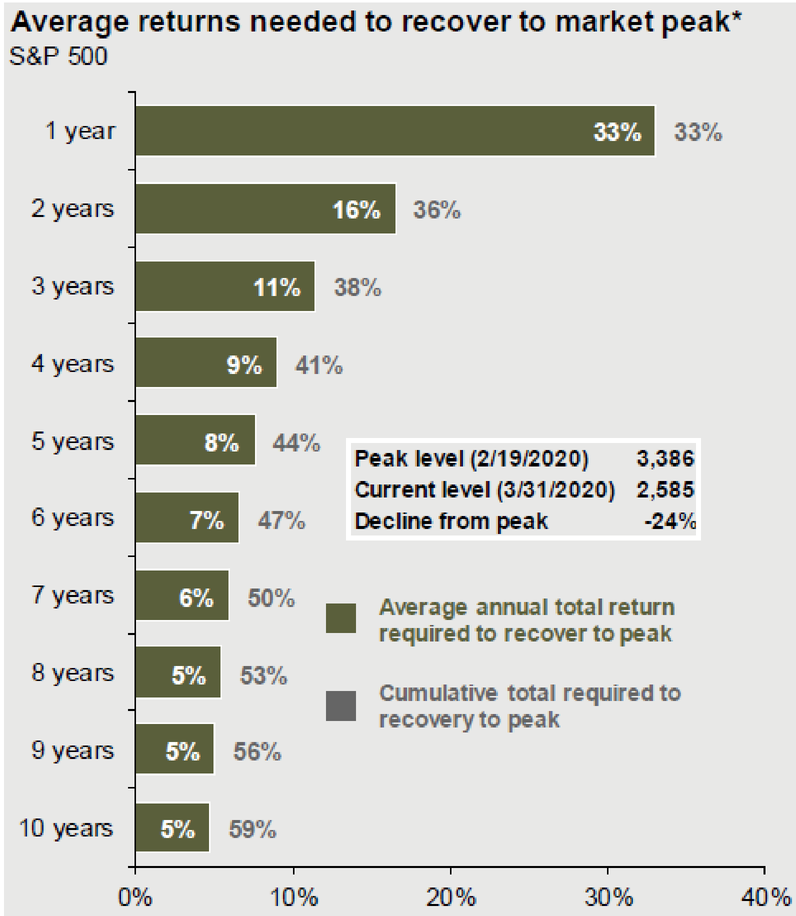
We talk about rebalancing in weak markets, and while we always attempt to buy at a discount to intrinsic value, we don't try to time the market or catch the bottom. Missing even a handful of the best days of market returns can hurt long-term performance. History shows that the best and worst days are usually tightly clustered, almost always within two weeks of each other. This makes sense because the worst days are often filled with the greatest emotion-based selling. People selling in capitulation usually need time to get back into the market and during this waiting period they are likely to miss some of the best return days.

- Between 1990 and 2019, there were approximately 9,867 trading days
- The average annual return over those 39 years was nearly 10%
- Missing the 25 best days over that period (one-quarter of 1.0% of that time) cuts the yearly returns in half!



Source: Dimensional Fund Advisors

We don't know how fast markets will regain their highs, but we feel confident that equities will provide the most attractive returns. We are rebalancing our existing positions to lower our cost basis, and adding new, high quality companies that fortify our portfolio for the future. The chart below demonstrates the potential paths to recovery in stock prices over the next few years. In short, the chart shows that if we regain the highs within two years, the annual returns are 16%; if it stretches out over five years, it's still an 8.0% annual return. This compares favorably to 2-yr and 5-yr government bonds, which yield 0.25% and 0.33%, respectively.



Source: JP Morgan Asset Management

Conclusion

"Our greatest glory is not in never falling, but in rising every time we fall." - Confucius

There is much about the current environment that is unfamiliar to us. We are tackling the uncertainty with a time-tested investment process, which gives us confidence that we can weather anything the market throws at us and come out of it stronger. As stewards of your capital, we remain focused and objective amid the uncertainty and the ongoing toll on our fellow citizens. We are optimistic that when we eventually emerge from this, we will have a portfolio of outstanding businesses that is even higher quality and capable of providing the returns and security you expect from us.

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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