HUTCHINSON CAPITAL MANAGEMENT

INVESTMENT PERSPECTIVES October 2013

Know What You Own

Why do you own individual stocks? This is a question that comes up from time to time when we meet with existing and prospective clients as well as other advisors. In today's world of investing, the strategy of owning a globally diversified group of mutual funds and exchange traded funds (or ETFs for short) has gained increased traction in the investment community. Some believe this diversification strategy reduces downside risk. Others use the argument that markets rise nearly 70% of the time[1] and therefore one should always be fully invested to participate in rising markets. At Hutchinson Capital Management, we view stocks as direct ownership interests in a business and as such prefer to thoroughly understand what we own. Our belief and historical record show that this strategy not only achieves outperformance in down markets but also allows capital to compound at a respectable rate over a number of years. Of course, we believe that in order for the strategy to work effectively, investors must follow a disciplined process of buying businesses only when they are available at attractive prices. We hope that this Investment Perspective will shed some light on how we view investing for our clients.

Two approaches to investing

Perhaps a reader can envision a scenario where he or she has the opportunity to invest in one of two business ventures which are organized to purchase multiple smaller grocery stores in the San Francisco Bay Area. One group chooses to purchase a store in every suburb and agrees to pay whatever price is necessary in order to close the acquisition, even if certain owners only agree to sell at valuation multiples far higher than historical deals over the past decade. Continuing its efforts to replicate the makeup of grocery stores citywide, the investment team purchases stores with questionable locations, including those located near a national grocery chain or stores residing in higher crime districts. In its investment pitch, the team proclaims that its investment portfolio is geographically diverse with 100 different locations in areas throughout the entire Bay Area. The team admits there will be winners and losers but boasts that the sheer number of stores will offer downside protection.

The other group chooses a different approach. This team pores over demographic data and looks for stores in locations that have higher population densities. The group speaks

[1] Ibbotson SBBI 2013 Classic Yearbook

with owners of grocery stores and evaluates which locations offer the best long-term potential and which should be avoided because they are near the toughest competitors. The team visits various stores and interviews customers, soliciting opinions about their shopping experience while simultaneously observing stores' traffic patterns and the distance to competitors. Additionally, the team spends time analyzing the financial results of each potential acquisition target and considers projections in a more challenging economic environment. Team members spend time talking with management, inquiring about how they pay themselves, pay other personnel and how they reinvest excess cash flow. Finally, the team only acquires stores at prices that they believe can generate returns in a variety of scenarios and abandons deals above this range. In contrast to the first group, team number two offers a portfolio of 20 stores but with voluminous notes about the reasons for each of its purchases. This second team also informs prospective investors that a substantial portion of the team's net worth will be invested alongside potential partners. The team admits that not every investment will succeed but the team stresses how it structures deals to minimize losses while noting that the success of only a couple of stores could have a meaningful impact on performance. Which team would you feel most comfortable partnering with?

How are we different?

As you can guess, we view ourselves as part of group two, and we passionately believe this is the more sensible choice. We read financial filings, proxies, and research reports to gain a better understanding of business and industry dynamics. We try to think about how business' free cash flow will look under a variety of scenarios and constantly ask ourselves where there could be flaws in our decision process. We spend time speaking with the businesses we invest with as well as industry and investment contacts who have worked in or invested in similar businesses, again trying to ensure our assumptions are accurate and to address any remaining questions. Finally, we select a purchase price that maximizes our odds of earning an acceptable return and walk away from prices that do not offer sensible risk/reward scenarios. While we spend significant time researching many different investment opportunities, we ultimately choose to invest in our top 20-25 stock ideas.

To give just one example of our due diligence process, we recently met with the CEO of Redwood Trust, one of our recent investments. We believe that the meeting added depth to our understanding of the company's dealings with other banks, its growth plans with conforming mortgages and mortgage servicing rights, its plan for operating when capital markets weaken and the company's views on capital management. We were also able to observe the body language of the CEO as we asked about his compensation and about his personal stock ownership. We believe this due diligence is invaluable and makes us more comfortable in a strategy that owns fewer companies that are well understood rather than more companies with less knowledge of each.

We understand that Hutchinson Capital Management's approach is not the only investment strategy an investor can choose (and we understand that we are hopelessly biased on our viewpoint). Many parts of the investment world recommend an approach not dissimilar to the investment group that buys grocery stores in every suburb. These advisors preach diversification, believing that by spreading investments over many different securities an investor can limit risk, can participate in rising markets, and can allow more time for an advisor to find new business. These practitioners recommend several different buckets of mutual funds and exchange traded funds (ETFs), each of which owns 100-200 stocks. With a portfolio of five different funds, there could be 500-1,000 stocks that make up the total portfolio. Even if the portfolio includes some wonderful franchises, the positions will be so small that there is going to be little impact to overall returns if a particular stock outperforms.

Interestingly, advisors particularly enjoy showcasing diversification on an international scale, believing that ETFs allow investors access to faster growing markets. Foreign ETFs also own large numbers of individual stocks, but unlike their domestic brethren these funds often own much larger percentages of individual names which dominate the total market capitalization of foreign stock exchanges. To pick one example, investors enamored with Brazil's faster economic growth rate might have selected shares in iShares MSCI Brazil believing such an investment provides 'diversification.' Unfortunately, the same investors may not realize that the same security has nearly a 12% weighting in Petroleo Brasileiro SA (Petrobras) securities. While we will not describe the problems with Petrobras in great detail (bloated capital spending budgets, political pressure to maximize employment versus profits, etc.), we would simply note that over the past couple of years, we have felt uncomfortable owning *any* shares in Petrobras, let alone making a concentrated bet on the name. In investing, diligence matters and we ultimately believe our meticulous approach will serve our clients better than trying to own a large number of investments that we either do not know or in some cases actively dislike.

Higher costs of over-diversification

We would note that there are meaningful costs to the above diversification strategy as funds and ETFs require an additional layer of management fees. In effect, clients pay twice, once to their investment advisor and once to the mutual fund or ETF. According to Morningstar, the average large cap mutual fund total expense ratio is 1.31% and for the ETF is 0.47%.[2] After adding these fees to the 1% or more investment advisory fee, combined fees can approach 2%, levels that are nearly double those at Hutchinson. And of course, these extra costs are before paying taxes. Individual stocks and bonds allow us to compound gains over multiple years, to harvest tax losses, and to utilize tax deferred accounts to shelter income. Our investing style, applicable to both stocks and bonds, maximizes tax efficiency and often allows our after-tax returns to nearly mirror our pre-tax numbers. While funds and ETFs generally do not discuss after-tax returns, we would note that these investment products offer far less tax flexibility and therefore likely produce weaker after-tax numbers.

Conclusion

In our opinion, owning hundreds and sometimes thousands of stocks is the not the best risk management tool. Instead, as value investors, we choose to manage risk by

[2] FINRA website: Tools & Calculators: Mutual Funds / ETF Total Operating Expenses

undertaking a thorough review of every security and by investing in names that provide an adequate margin of safety. Since the firm was founded in 1995, we have managed our client investments in the same manner: purchasing 20-25 high quality businesses trading at discounts to their true value and investing our capital in the same names as our clients. By maintaining the same disciplined process in strong and weak markets, we believe our research intensive approach offers a better way to protect and grow our clients' assets in the years ahead.

PLEASE SEE IMPORTANT DISCLOSURES BELOW:

As of September, 2013, Hutchinson Capital Management (HCM) held:
500,985 shares of Redwood Trust (RWT)
0 shares of Petrobras (PBR)
0 shares of i-shares MSCI Brazil (EWZ)

As of September 30, 2013:
Redwood Trust closed at $19.69
Petrobras closed at $15.49
MSCI Brazil closed at $47.91

As of September, 2013, the following were the ten largest holdings of HCM:

Name of Issuer	% of Equity Portfolio	09/30/13 Closing Price
JOHNSON CONTROLS INC	6.6%	$41.50
GENERAL MOTORS CORP.	6.4%	$35.97
MICROSOFT CORPORATION	5.8%	$33.28
WELLS FARGO & CO	5.7%	$41.32
OMNICOM GROUP INC	5.3%	$63.44
CVS CAREMARK CORPORATION	5.1%	$56.75
MARKEL CORP COM	5.1%	$517.77
BANK OF NEW YORK CO (New)	5.0%	$30.19
EMERSON ELECTRIC CO	4.9%	$64.70
CHUBB CORPORATION	4.2%	$89.26

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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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.

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