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INVESTMENT PERSPECTIVES

The North Star

On any clear night, anywhere on the planet, a person can look up into the sky and find The North Star. We have come to know this star in English as, *Polaris*, named during the Renaissance from the Latin term meaning “of/near the North Pole.” For centuries it has served as a beacon to help lost travelers find their way. Due to its ubiquity, it has many names in many languages, but common to all is the theme of constancy and steadfastness. The expression, “count your lucky stars” originates from the importance this star played in helping people navigate to safety. While technology has solved our modern navigational challenges when it comes to geography, the fear of becoming lost amid financial uncertainty is no less frightening to us today than it was to a 15th century ship captain alone on a vast ocean.

At Hutchinson Capital we strive to be that beacon of consistency and steadfastness for our clients. Our team is dedicated to protecting your hard-earned wealth. We will always provide objective advice whether it concerns wealth management, major life events/transitions, or personal matters. As fiduciaries, the interests of our clients come first and every member of our team possesses the integrity to earn clients’ trust over the years. The confidence we have in our investment process and methodology is demonstrated by the alignment of our own interests with those of our clients; our company retirement plan is invested in the same securities as our clients.

Clients can rely on us to adhere to a consistent set of core principles:

- ***Consistency of the investment process***: we strive to provide solid returns over the long term using a time-tested, value based approach
- ***Consistency of client service***: our goal is to provide superior personalized service

For us, consistency begins with culture. Every member of our team understands that each of us must possess fundamental qualities integral to sustaining a successful investment counseling firm. The values and principles of our culture touch every facet of our business, from how we invest to how we treat clients and each other. Internally, we share ideas and work collaboratively to maximize our time and effectiveness. Because of the importance we place on transparency, we regularly communicate our investment rationale to our clients; we do this through position papers on each investment and client reviews.

Maintaining consistency of our investment process is crucial and requires discipline at times. There are market environments that favor our investment style and others that don't. We can't control that, but we can promise that we will remain disciplined and not take risks which cause us to deviate from our dedicated goal of stable asset growth in a framework of capital preservation. We apply a time-tested valuation methodology based on finding companies that can generate solid earnings and cash flow over a three to five year investment horizon. This is hard work and there are periods when the market doesn't reward our efforts.

Different investment styles go in and out of fashion over the years. Most of the time investors differentiate companies based on their fundamental characteristics; at other times, such distinctions are ignored. Even when fundamental value investing seems out of synch, we maintain our discipline and consistently apply our methodology. Companies that we buy must have a proven ability to grow the value of their franchise over the long term. To us, this means a management team that finds opportunities to deploy capital intelligently toward businesses that generate superior returns at acceptable levels of risk. It sounds easy, but it's not. And as investors, it's also not easy to find such investments at prices that offer compelling returns with a reasonable margin of safety. Over the years, our investment process has adapted to change but its principles remain the same and have been successfully applied for over 20 years. Clients who entrusted us with their money yesterday, know that it will be managed in the same way tomorrow.

Mr. Market is Not Your Friend

We are investors in individual companies, but that doesn't mean we can simply ignore all the factors affecting the overall market and economy. Being an investor means being part financial analyst and part psychologist. Warren Buffett made this point vividly in his 1987 Berkshire Hathaway Shareholder Letter, wherein he described his view of Benjamin Graham's invented persona, ***Mr. Market***:

> *Ben Graham, my friend and teacher, long ago described the mental attitude toward market fluctuations that I believe to be most conducive to investment success. He said that you should imagine market quotations as coming from a remarkably accommodating fellow named Mr. Market who is your partner in a private business. Without fail, Mr. Market appears daily and names a price at which he will either buy your interest or sell you his.*
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> *Even though the business that the two of you own may have economic characteristics that are stable, Mr. Market's quotations will be anything but. For, sad to say, the poor fellow has incurable emotional problems. At times he feels euphoric and can see only the favorable factors affecting the business. When in that mood, he names a very high buy-sell price because he fears that you will snap up his interest and rob him of imminent gains. At other times he is depressed and can see nothing but trouble ahead for both the business and the world. On these occasions he will name a very low price, since he is terrified that you will unload your interest on him.*

Mr. Market has another endearing characteristic: He doesn't mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one tomorrow. Transactions are strictly at your option. Under these conditions, the more manic-depressive his behavior, the better for you.

But, like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice: Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom, that you will find useful. If he shows up some day in a particularly foolish mood, you are free to ignore him or to take advantage of him, but it will be disastrous if you fall under his influence. Indeed, if you aren't certain that you understand and can value your business far better than Mr. Market, you don't belong in the game.

In order for us to take advantage of Mr. Market, we need him to have his usual mood swings. For stocks to get cheap, his mood must grow depressed. But since the Great Financial Crisis of 2008-2009, our old partner has been receiving a steady dose of mood stabilizers, compliments of the global central banks. During this extended period of sedation, stock price behavior has been dominated by factors unrelated to individual company fundamentals. As such, they have tended to move as one. This type of environment does not reward the skill of security analysis, but rather proves more amenable to strategies that don't attempt to differentiate between individual companies. Wall Street has responded in typical fashion by serving up a smorgasbord of investment products catering to the undiscriminating. Thousands of exchange traded funds (ETF's) and passive investment strategies have blossomed to meet the flood of money seeking cheap and easy investing solutions. This has made our job harder in the short term, and while we are finding the occasional opportunity, we maintain our discipline and await a more constructive environment.

In the long term, this flood of money and herd-like behavior will benefit us. As they did during the Technology Bubble 15 years ago, when the fad was that a new paradigm rendered fundamental analysis useless, investors abandoned stable and unexciting companies in order to run with the herd. As value investors, we were able to find attractive opportunities among the abandoned and discarded. During this current cycle, the herd has crowded into cheap products such as ETFs marketed as "low volatility" or "high dividend yield." In the current investment climate of artificially low rates and uncertain valuations, this is an easy marketing pitch and large flows of investor money have poured into these products. Investors have abandoned many cyclical companies and it has been among these that we have found value.

1+1=3

Consistency of our investment process does not mean that we are inflexible and unwilling to adapt to change. Our industry is undergoing significant changes and we are constantly adapting in order to provide the highest quality service. One major change that receives a great deal of attention, and conjures up fear among many asset managers, is the increasing role of technology and the many ways it may alter the investment landscape. At HCM, we see advanced computing as an ally rather than a competitor. We view our

business as customer-oriented and technology can help us do a better job of it. The currently popular buzzword, "Big-Data" is not new to us. We already use massive databases of raw financial data to mine for fundamental variables in a continuous search for companies that meet our investment parameters.

What is new, however, is the use of data to conduct predictive analytics. Artificial intelligence (AI) engines comb through both quantitative and qualitative data in order to identify investable trends. While sophisticated AI robots fascinate us with feats like Jeopardy! contests, chess wins, and a recent victory against the world's best human GO champion, the process of investing is incomparably complex. Predictive analytics, applied to autonomous investing will likely be very successful in short term tactical endeavors, but making predictions of the future, based solely on information from the past, will be difficult to implement in a long term buy and hold strategy. A less sensationalized story, but far more encouraging outcome resulted when humans were teamed up with machines to compete against the top AI engines; in these contests, it was the combined talent of man and machine that proved unbeatable.

Computers may perform a growing share of the data analysis, but there is no substitute for sound judgment—human judgment, making decisions based on an individual client's specific needs. Technology helps us do this. One analogy that we find apropos is to think of machines as useful tools to *collect*-the-dots, efficiently gathering and sorting raw data, while we *connect*-the-dots, using judgment and experience to best apply that knowledge.

Conclusion

Providing reliable service and sound investment returns based on the application of a consistent analytical methodology is deeply embedded in the culture at Hutchinson Capital. Consistency, however, does not mean staid and non-adaptive. The principles of Cash Economic Value Analysis[1] do not really change over time, but how we apply our knowledge and compete in the marketplace does require adaptation. As investors, we are constantly in search of market inefficiencies; in this long, post-crisis environment, it has become fashionable to declare that the value of fundamental analysis has been rendered obsolete. At Hutchinson Capital, we believe it's important to fully understand the companies we own, and therefore we choose to conduct deep research, regardless of the time and effort required. Even if our investment style is currently unfashionable, it's not an environment we haven't seen before. Ben Graham faced pressure and ridicule in the early 1920's; Warren Buffett once answered a question about why he bothered doing such intense analysis by saying, *"Investing without considering the value of the companies you buy is like playing poker without thinking it's important to look at your cards."*

[1] Cash Economic Value Analysis converts reported financial data into cash earnings so that a company's true earnings power can be evaluated in the absence of discretionary accounting decisions.

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.

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