April 2018

INVESTMENT PERSPECTIVES

Know What You Own

You are what you eat, so the saying goes. Just as most of us care about the quality of the food we eat, and want to know what's inside the stuff that goes inside our bodies, we think similarly about what goes into our portfolio. Our approach to common stock investing is grounded in the belief that it should be conducted with the same care, commitment, and thoroughness that one would undergo if purchasing an entire enterprise. This means discriminating between companies based on characteristics we know to be crucial to long-term value creation. In this Investment Perspectives we will compare and contrast the investment process we use at Hutchinson Capital Management, with the currently popular trend toward more passive or indexed strategies.[1]

Investing, regardless of the process one uses, involves some element of risk. No matter how we define risk, it is something we try to manage. Risk is best assessed when we have the most detail about our exposures. In this way, we can isolate the risks we intend to take from those risks we cannot avoid. This begins with the asset allocation decision and works all the way down to the individual stock and bond selection. By controlling the investment process down to the most basic component, we have the clearest possible picture of our portfolio risk.

Ordinarily, selecting stocks that are inexpensive, while avoiding those that are overpriced minimizes risk and provides the best long-term returns. The unusual economic conditions which have affected markets, have diluted the normal competitive advantages we derive from our research process, and favored passively managed index strategies. Like most research-focused managers, we favor companies with strong financial characteristics relative to those with poor financials but, for long stretches of this policy-fueled market rally, the stocks of companies with poor fundamentals actually outperformed companies with strong fundamentals.

- With the start of the Fed's 3rd round of quantitative easing (QE3) in 2012, buying $85bil of securities per month, policy makers created a three-year binge of risk-taking[2]
- Over the next three years, stocks with negative earnings rose 95% while stocks with positive earnings rose only 68%
- Within the Russell 2000, the most highly levered companies outperformed the index by 40%
    - Only 10% of Russell 2000 companies carry investment grade credit ratings
    - 30% of companies in the index have negative earnings
- Indiscriminate buying pressure raised correlations by 19% and lowered price dispersion by 31%
    - Higher correlations mean all stocks move in closer coordination (bad for fundamental stock pickers)
    - Lower dispersion means high quality companies show few performance advantages over lower quality

These distortions occur because money flowing into index products means that stocks that are index members automatically see inflows of capital; these capital flows are based on their membership in the index and their market cap rather than their fundamentals. This has been a long, nine-year market cycle, but we have only seen half of it so far—only the up-cycle. When a full market cycle is considered, the price vs. fundamental results will be profoundly different.

- Historically, unprofitable companies underperform profitable ones over longer time frames

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[1] A passive investment strategy is one in which an investor commits money to an investment plan without concern to price, time horizon, or risk. It is assumed that an infinite time horizon alleviates investment risk because asset prices always risk (eventually); an index strategy is one whereby the investor buys an entire index of stocks or bonds without trying to discern whether some individual securities might be better than others.

[2] Unusually low interest rates change investor risk preferences, pushing them toward long-duration cash flow streams and higher-risk balance sheets.

- In the last full cycle, stocks with positive earnings rose 203%, while stocks with negative earnings fell by 21%

The sheer dollar volume of assets shifting toward passive investment strategies is staggering. We think it poses risks to financial markets that may not be broadly appreciated by most investors.

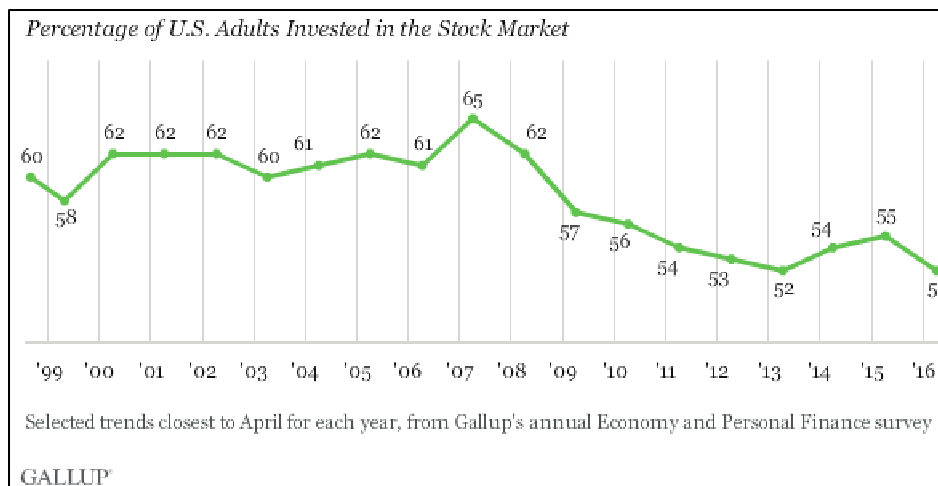
- When we see the other side of this market cycle, the value of active oversight will come back into focus
- In a declining market, at a certain point, fundamental quality will command a premium again

We can't control the changes in market prices of the securities in our portfolio, but we make certain that we understand why our companies' stocks are performing the way they are. In contrast to a passive approach, when value opportunities are hard to find, we act directly, by raising cash levels and making sure our clients do not own the most expensive stocks in the market. By their very nature, index funds will overweight the stocks and industries that have already performed best and are likely to be the most expensive.

We apply an opportunistic approach to investing, whereby we constantly monitor our portfolio and the markets for risks and opportunities. This approach is natural for people to understand because it resembles the way most of us live our ordinary lives. When prices of goods are absurdly high, we wait for bargains or look for sensible alternatives; most sensible people don't buy more of something because its price is higher.

Another important aspect of active portfolio oversight is helping clients overcome some of the behavioral aspects inherent in the investing process. These behaviors are most powerful at market peaks and troughs. In the current market cycle, stocks were peaking just as individual investors were entering the market in record numbers. The market bottomed in March 2009, but investors continued selling for four more years-just when they should have been buying. Stock ownership declined for seven years, before starting to tick back up. As investors came back to equities, many found it more expedient and less complicated to buy broad, structured products rather than trying to pick individual stocks. This makes sense to us, up to a point, but now that we are near the top of the cycle, the trade has become dangerously crowded.

- Since 2003, Exchange Traded Funds (ETFs) have grown from $200bil in assets under management (AUM) to $4T in 2017
- Among S&P 500 companies, total share ownership by passive funds ranges from 10% to 35%, averaging 17%
- ETFs now account for 30% of all trading volume, up from 2% in 2000
- Assets dedicated to passive investment strategies (equities and fixed income) totaled $6.7T at 12/31/2017



If one man can be considered the father of passive/indexed investing, it would be John Bogle. Long associated with The Vanguard group, he has always been the product's most vocal cheerleader. His basic argument supporting indexing is as follows:

> *"Simply by buying a portfolio that owns the shares of every business in the United States and holding it forever is a simple concept that guarantees you will win the investment game played by most other investors who, as a group are guaranteed to lose."*

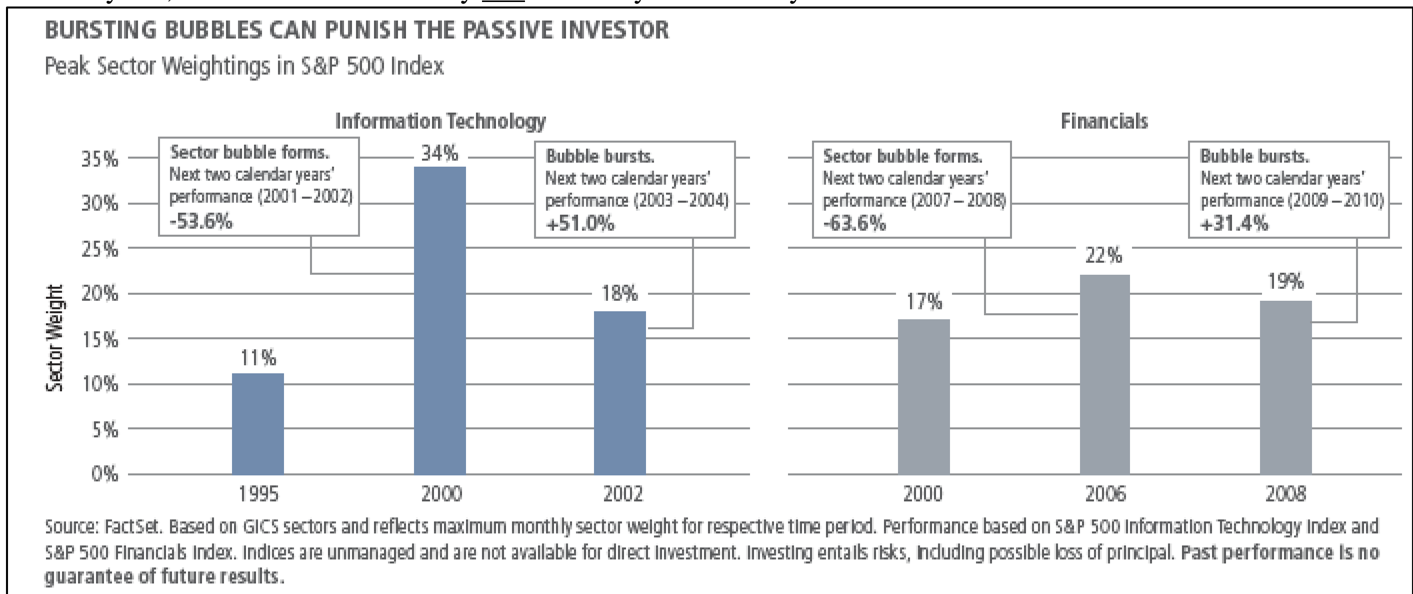
When investing, beware of anything proposed to fit the universal needs of every investor. The investing process must be blended with each individual client's needs and a lot can happen between now and forever. Financial planning requires forward thinking to assess future cash needs and risk tolerances, factors unique to each client's situation.

Stock prices in the marketplace are not completely objective; they reflect economic factors such as corporate profits, but they also embed the collective psychology of all market participants. This collective psychology is subject to "persuasion" or the varying moods of the markets. As such, when buying an index product, one must bear in mind, that this is a pure price bet. Additionally, since most indexes are constructed based on each stock's market capitalization, whether intended or not, the investor is making a kind of momentum bet. This is the case because, at any given time, the index will be weighted most heavily by the companies which have already experienced the greatest price moves. Also, risk will be concentrated among the industries that are currently the most popular. As the chart below demonstrates, this can be particularly hazardous to passive investors when psychological influences are most profound (Tech bubble and Financial bubble).

- As the Tech bubble inflated between 1995-2000, the IT Sector grew, as percent of the S&P, from 11% to 34%; as it deflated, the sector declined by ~54% and settled at 18% of the total S&P weight
- The Financial sector grew from 17% to 22% of the S&P, and its deflation resulted in a ~64% decline in price for the sector which settled at a weight of 19%

Owning every company in the market does not take into consideration those companies succeeding at the expense of competitors. Holding too many stocks dilutes the competitive advantage of research knowledge while still leaving the manager exposed to the behavioral risks associated with the investment process.

We use our knowledge to concentrate our focus on businesses which we believe will deliver superior returns over five to ten years. In order for us to demonstrate this to our investors through superior returns, it must be observed over multiple market cycles, but we have been in only one market cycle for nine years.



Source: FactSet. Based on GICS sectors and reflects maximum monthly sector weight for respective time period. Performance based on S&P 500 Information Technology Index and S&P 500 Financials Index. Indices are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

Maximum diversification is a key tenet of the index approach. It is the belief that risk is reduced by owning a small piece of every company rather than trying to use research to pick the best companies. With each position so small, no single, underperforming company can unduly influence performance. We agree that certain risks are reduced by diversifying into a mix of companies exposed to different economic factors, but we believe knowledge is the more powerful risk reducer. As John Maynard Keynes wrote in 1934,

> *"As time goes on, I get more and more convinced that the right method in investment is to put fairly large sums into enterprises which one thinks one knows something about and in the management of which one thoroughly believes. It is a mistake to think that one limits one's risk by spreading too much between enterprises about which one knows little and has no reason for special confidence. One's knowledge and experience are definitely limited and there are seldom more than two or three enterprises at any given time in which I personally feel myself entitled to put full confidence."*[3]

When we invest in a company, we are expressing an active view not only regarding its fundamentals, but also the quality and integrity of its management. By quality we mean more than just their ability to manage the business and generate strong returns on invested capital, but also the quality of their corporate citizenship; we use a comprehensive

[3] Excerpt from an August 15, 1934 letter from JMK to F.C. Scott.

Environmental, Social, and Governance (ESG) evaluation model which scores each company based on 65 Environmental, 76 Social, and 101 Governance factors.

We are concerned about the potential risks posed by the massive flows of money into passive strategies. This momentum-fueled trend is self-reinforcing and transmits enthusiasm into price gains in a frictionless manner. It has been easier to inflate because the money behind it is transmitted to prices immediately. In this unique case, as more capital flows to the indexes and provides buyers instant gratification through higher prices, this, in turn, attracts more capital. But the capital can flow back out just as easily, with potentially severe consequences for stock prices and investor confidence. We are worried about market liquidity risk when this trade unwinds.

- For most of its 40-year history, index funds commanded less than 10% market share
- Since the introduction of QE in 2008, that share has grown to 30%
  - Stock positions held by indexes have grown from $900mm in 2005 to over $4T today

Given the fact that more than 90% of index vehicles apply a market-cap weighted approach to portfolio construction, money flows—and not business fundamentals—have been a primary driver of price increases in recent years. This is not capitalism, however, and we believe that ultimately the most deserving business models will again attract capital at the expense of the less deserving. It is our firm belief that with the normalization of economic conditions, other investors will return to common sense investing. This is beginning now as investors are facing a new, less certain environment.

- Economic conditions are changing
- Interest rates are rising
- There is a return of interventionist fiscal policy (tax cuts and infrastructure spending)
  - These efforts target specific areas of the economy rather than the economy as a whole
  - This will lead to a more uneven growth trajectory for countries, industries and, ultimately, asset prices

Less predictable and/or steady growth rates and normal asset-price correlations, should naturally benefit active portfolio managers, who are able to take advantage of mispricings and emerging economic trends.

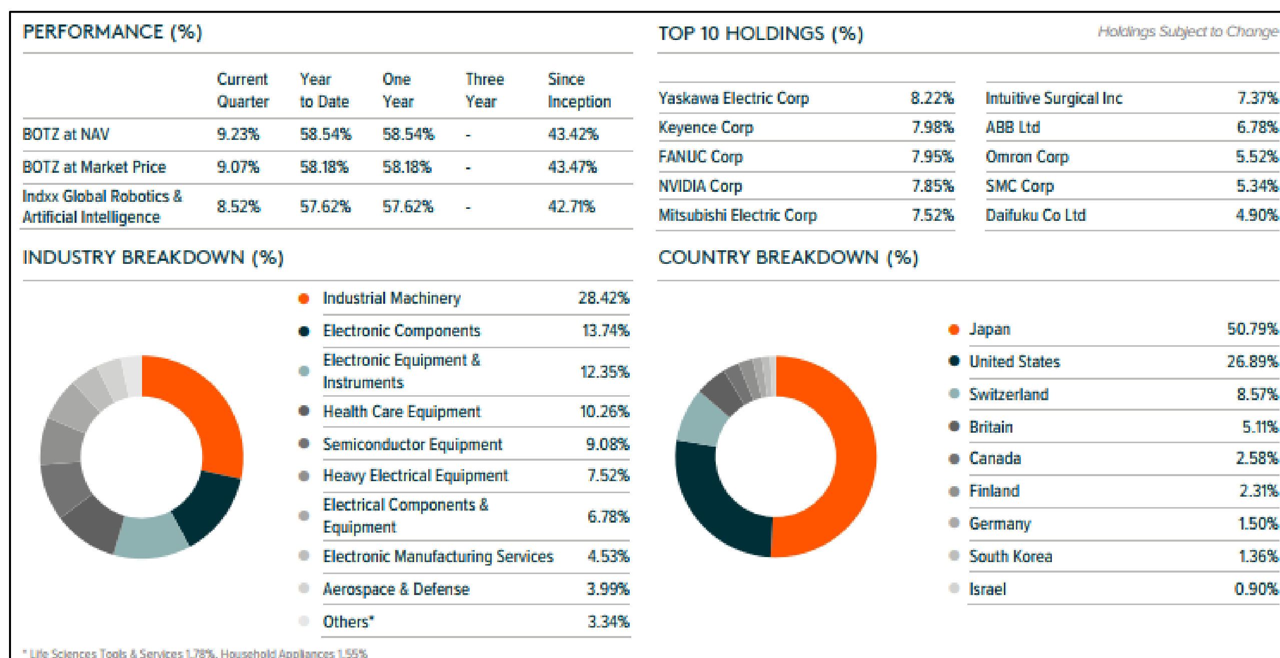
Conclusion

- While we appreciate the inefficiencies created by passive strategies, this does not come without potential risks
- Proper investment plans require a concrete risk management plan beyond merely holding forever
  - We use a disciplined Upside/Downside Framework for each company in our portfolio, and we actively manage those positions with an opportunistic mindset
  - Passive strategies, by their nature, are not designed with the client's risk concerns accounted for
- Change can be unsettling, and we think asset prices are at risk, but we're looking forward to a market environment better suited to fundamental investing

Case Study Example:
We have appended the following case study to demonstrate, in real-world terms, the importance of doing the core investment research and understanding exactly what you own when purchasing a stock, bond, index fund, or ETF. We have said before that outcome and process are different things. When buying theme-oriented investment product, even though the price may work in the investor's favor, it may be for reasons of sentiment rather than fundamentals. And while this may work out for a time, sentiment is a tricky and fickle animal that can change suddenly and inexplicably.

A popular investment theme today is robotics and artificial intelligence, and the most popular vehicle used by investors wanting exposure to that theme is the Global X Robotics & Artificial Intelligence ETF or "BOTZ." To create an investable ETF, its marketers bundle a group of companies with a business mix related to the desired practice. There are factors beyond the fundamental aspects of robotics and artificial intelligence that may have a profound effect on the price of this security. The details of these particularities can be gleaned only by reading a 111-page Global X Funds prospectus, which we did of course.

One disclosure that stands out to us is, "*Fund assets will be concentrated (that is, it will hold 25% or more of its total assets) in companies that provide exposure to the robotics and artificial intelligence industry.*" Investors buying this ETF are doing so because they want specific exposure to the robotics/AI investment theme, but the vehicle is only required to have 25% of its total assets invested in that theme. When you combine that with the fact that only a portion of each company's business is actually related to robotics and AI, it's possible that buying the BOTZ ETF will not be as leveraged to the fundamentals of robotics and AI as the investor thinks.



PERFORMANCE (%)

	Current Quarter	Year to Date	One Year	Three Year	Since Inception
BOTZ at NAV	9.23%	58.54%	58.54%	-	43.42%
BOTZ at Market Price	9.07%	58.18%	58.18%	-	43.47%
Indxx Global Robotics & Artificial Intelligence	8.52%	57.62%	57.62%	-	42.71%

TOP 10 HOLDINGS (%) *Holdings Subject to Change*

Holding	%	Holding	%
Yaskawa Electric Corp	8.22%	Intuitive Surgical Inc	7.37%
Keyence Corp	7.98%	ABB Ltd	6.78%
FANUC Corp	7.95%	Omron Corp	5.52%
NVIDIA Corp	7.85%	SMC Corp	5.34%
Mitsubishi Electric Corp	7.52%	Daifuku Co Ltd	4.90%

INDUSTRY BREAKDOWN (%)

Industry	%
Industrial Machinery	28.42%
Electronic Components	13.74%
Electronic Equipment & Instruments	12.35%
Health Care Equipment	10.26%
Semiconductor Equipment	9.08%
Heavy Electrical Equipment	7.52%
Electrical Components & Equipment	6.78%
Electronic Manufacturing Services	4.53%
Aerospace & Defense	3.99%
Others*	3.34%

* Life Sciences Tools & Services 1.78%, Household Appliances 1.55%

COUNTRY BREAKDOWN (%)

Country	%
Japan	50.79%
United States	26.89%
Switzerland	8.57%
Britain	5.11%
Canada	2.58%
Finland	2.31%
Germany	1.50%
South Korea	1.36%
Israel	0.90%

At HCM, we don't invest to gain exposure to a specific theme unless the fundamentals support it. One of the holdings, however, FANUC Corp, is a company with which we are familiar. It is a near pure-play robotics company, based in Japan. We are monitoring the company, but it's a bit too expensive for us now. There's a chance, that at the right price, we might purchase FANUC. The ETF's methodology of giving the investor exposure to AI/robotics is a shotgun approach, compiling scattered pieces of different companies, each with varying exposures to the desired theme. Our process is more precise: if an economic driver is strong enough to be an industry catalyst, we will single out the best company that happens to be benefitting.

BOTZ holdings are spread around the world with 51% of the 34 companies in the vehicle domiciled in Japan, 27% in the US and 9% in Switzerland. Its largest holding, ***Yaskawa Electric Corp***. is a fascinating company, but not a pure-play robotics company by any means; only 35% of total company revenue stems from robotics-related activities. ***Keyence***, another Japanese company, does not report segment data, but we were able to ascertain that most of its business is related

to sensor technology; sensors are key to robotics, but this company makes sensors for all manner of products, not only robotics.

A US investor buying this product should be aware that the high concentration of Japanese companies contained in it will make the price of the instrument susceptible to volatility in the foreign exchange relationship between the US dollar and Japanese Yen. Since its formation, it has traded with a 92% correlation[4] to the NASDAQ 100 index, despite only 27% of its companies being from the US. The enthusiasm for large-cap technology companies has driven buyers into this ETF. It's also not inexpensive, BOTZ charges the investor a 68bps fee each year despite being passive, only rebalancing annually and doing nothing on the investor's behalf. A successful investment in BOTZ depends in part on the fundamentals of each company inside the ETF, but perhaps more importantly, it depends on continued investor enthusiasm for the concept underlying it.

[4] A 92% correlation between BOTZ and the NASDAQ 100 Index means that, historically, for each $1.00 price move in one of the securities, the other security moved $0.92. This is considered a very high correlation.

PLEASE SEE IMPORTANT DISCLOSURES BELOW:
As of April 11, 2018 Hutchinson Capital Management (HCM) held:

0 shares of GLOBAL X ROBOTICS & ARTIFICIAL INTELLIGENCE (BOTZ)
0 shares of FANUC CORP. (FANUY)
0 shares of YASKAWA ELECTRIC CORP. (YASKY)
0 shares of KEYENCE CORP. (KYCCF)

As of April 11, 2018

GLOBAL X ROBOTICS & ARTIFICIAL INTELLIGENCE (BOTZ) closed @ 23.71
FANUC CORP. (FANUY) closed @ 25.19
YASKAWA ELECTRIC CORP. (YASKY) closed @ 25.19
KEYENCE CORP. (KYCCF) closed @ 585.66

As of March 31, 2018, the following were the ten largest holdings of HCM:

Name of Issuer	% of Equity Portfolio	03/31/2018 Closing Price
INTEL CORPORATION	6.15%	52.08
ROBERT HALF INTERNATIONAL INC	5.78%	57.89
NATIONAL OIL WELL VARCO	5.73%	36.81
MARKEL CORP COM	5.69%	1170.25
JACOBS ENGINEERING GR	5.61%	59.15
WILLIAMS-SONOMA INC	5.34%	52.76
MOSAIC CO NEW COM	5.32%	24.28
CARNIVAL CORPORATION	5.18%	65.58
NOVO-NORDISK A S ADR	4.94%	49.25
WELLS FARGO & CO	4.67%	52.41

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.
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