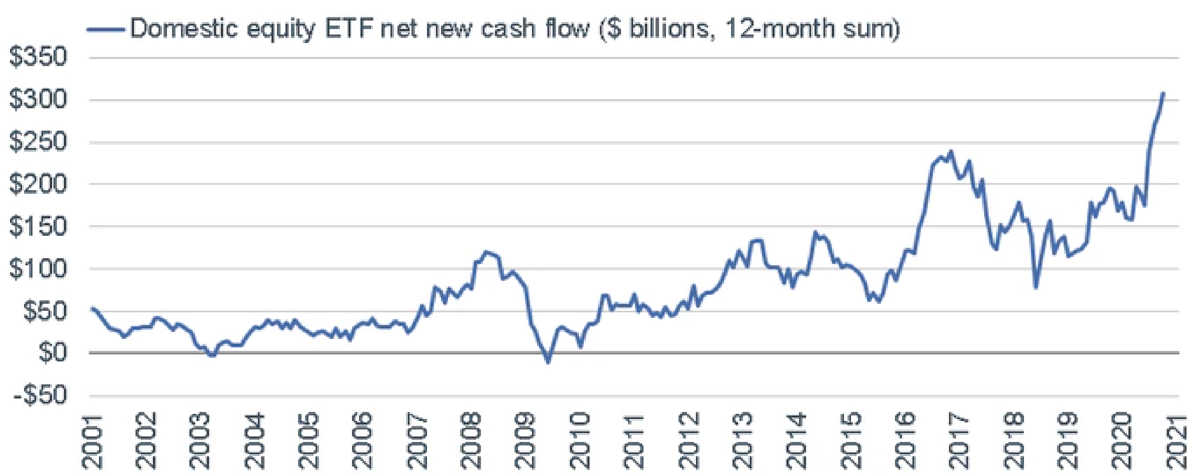
Hutchinson
CAPITAL MANAGEMENT

July 2021

<u>Preservation of Capital</u>

At HCM, our approach is to invest our clients' capital to preserve value and purchasing power over long periods of time. Clients have worked hard to grow their money over the decades. They are diligent savers who have been through many stock market cycles. They have experienced both the fear and greed in markets. We believe we are currently in one of those "greedy" cycles. Preservation of capital may seem contrarian or "out of step" in the current times when money is cheap, and a lot of capital, as shown by the chart below, is chasing fewer opportunities leading to high asset valuations. Yet, as always, we stick to our process. In this letter, we go through our investment process in times of market excesses.

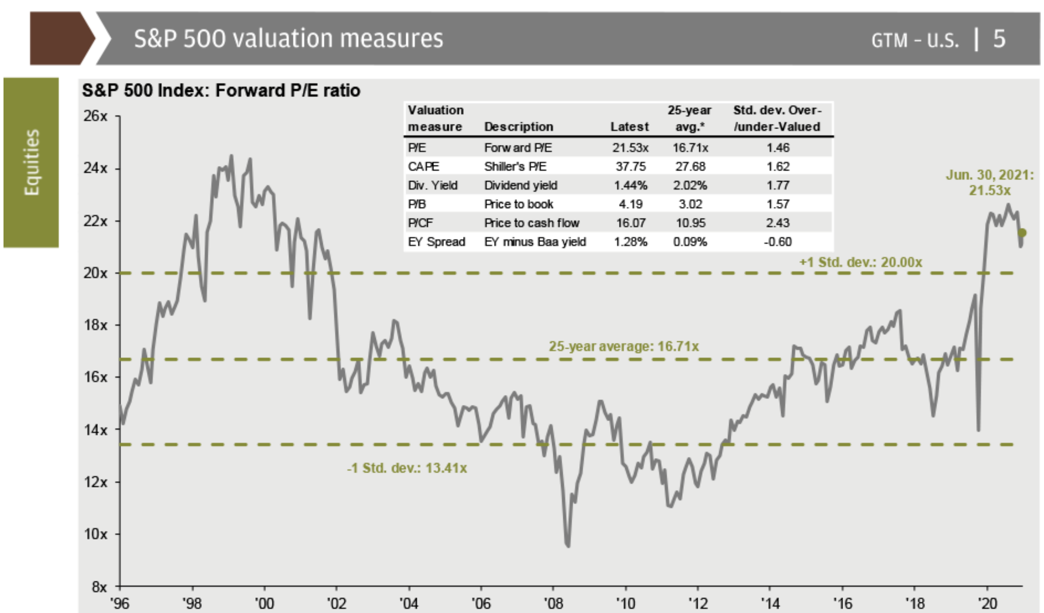


Source: Charles Schwab, Investment Company Institute (ICI), as of 5/31/2021.

Our investment policy includes purchasing growing and financially sound companies that produce measurable cash flow. We then value them and try to make sure we are not paying too much. We believe this is the secret to good long-term returns. The future is difficult to predict, as earnings of companies fluctuate. When investing in a new company we seek a price that provides us an appropriate margin of safety i.e., we try to buy it at a discount to what we think its worth. Generally, a company is attractive to us when the outlook for that company is uncertain in the public eye and the price has dropped significantly. A situation like this presented itself last year when the market fell abruptly in March of 2020. We took that opportunity to acquire new positions in high-quality companies whose market values had fallen precipitously. Conversely, when the consensus outlook is very good and the price of a stock has risen significantly, we tend to be more cautious. This phenomenon is happening in certain portions of the market now.

The Covid virus has brought about a lot of change, some of it is long lasting like increased teleconferencing and some of it may be more transitory like the "death of the office." This has led to an increased interest in new technologies that are exciting and make our lives easier. While we invest in companies in the technology sector, we prefer companies that exhibit utility-like characteristics: those whose services are required, provide predictable revenue streams, and, in most cases, recession-resistant qualities.

Covid has brought millions of new investors into the market since the beginning of the pandemic. Retail trading had a record year in 2020, and the activity has not slowed down through the first half of 2021. While headlines have been dominated by meme stocks and stories of the like featuring extreme speculation, not all the investors who have begun their investing journey over the past 18 months are purely short-term risk takers. Many are those who have done their homework and want to make educated decisions to grow their wealth. However, many more have been allured by the headlines of easy money over short timelines. This has proliferated the notion that "investing is easy" or "the market always goes up." We must remind ourselves as our days return to normalcy that the year of 2020 and the pandemic was an anomaly unlike anything we have ever seen. The sharp rebound from the market decline last spring has distorted return expectations going forward for the massive influx of new investors over the past year. As seen in the chart below, we are well-above long-term historical (25-year) averages on various valuation metrics. Bottom-line, stocks are expensive relative to historical norms.



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	21.53x	16.71x	1.46
CAPE	Shiller's P/E	37.75	27.68	1.62
Div. Yield	Dividend yield	1.44%	2.02%	1.77
P/B	Price to book	4.19	3.02	1.57
P/CF	Price to cash flow	16.07	10.95	2.43
EY Spread	EY minus Baa yield	1.28%	0.09%	-0.60

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.
Price-to-earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since June 1996, and J.P. Morgan Asset Management for 6/30/21. Current next 12-months consensus earnings estimates are $200. Average P/E and standard deviations are calculated using 25 years of IBES history. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-months consensus dividend divided by most recent price. Price-to-book ratio is the price divided by book value per share. Price-to-cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 25 years for each measure.
Guide to the Markets – U.S. Data are as of June 30, 2021.

Preservation of capital does not just mean protecting the portfolio in euphoric markets. As we wrote about in our *Investment Perspectives* last quarter, we favor companies that have the power to raise prices if their input costs rise. These types of businesses help ensure that the company's earnings account for inflationary pressures. This ultimately gets reflected in the market values of the company. A few examples of the industries we like (and hold such companies in your portfolio) are banks, insurance companies and car dealerships. The companies in those industries allows them raise prices in inflationary environment. Using this approach helps us further in preserving the purchasing power of your capital.

Our approach to acquire high-quality companies with strong financial positions also helps in preserving capital. Even if these companies go down during a period of stress, their market values tend to come back when the equity market stabilizes. We prefer to hold companies for three to five years or longer if possible. Within these periods there will be times when stock prices drop due to many circumstances. We are always prepared to add to an existing stock we currently hold.

Additionally, we strongly believe that a portion of client's capital should be invested in high-quality bonds (this may differ based on the individual client situation). The capital invested in bonds acts as a shock absorber during the period of stress in the equity portfolio. This enables a portfolio's performance to be less volatile in both strong markets and weak markets and tends to deliver more consistency over long periods. We have found this stability has helped families to stay the course. We realize our clients think in terms of dollars and not percentage. When we speak with you, we are cognizant of the fact that a sudden increase in your wealth will not change your behavior, but a large loss (from buying stocks at high prices), on the other hand, might mean a significant change in lifestyle. That is not an outcome we are comfortable with.

In our view, patience in investing translates into both capital preservation and long-term compounding. When we invest in a new company, we assess a company's prospects for the next three to five years. By contrast, the vast majority of Wall Street analysts are focused on a company's outlook for the next quarter or year at the most.

Often, we believe that taking "no action" is the best action. There seems to be an inherent human tendency to "be active" rather than establishing the discipline and patience to invest for the long-term. Warren Buffet likes to use analogies. One of his favorites is that "The stock market is a no-called-strike game." In other words, we can let hundreds of pitches go by i.e., mediocre investment ideas… just waiting for the sweet one. The overriding obsession with this focus on "taking action" can create opportunities for contrarian investors like us who are willing to wait and assume a long-term perspective.

We cannot stress enough the importance of investing with capital preservation in mind. This journey we are on together is a marathon, not a sprint. Sometimes, it's sunny out, the wind is at your back, and you hit a downhill. It seems easy. We feel we are in one of those times. No one has any idea when exactly the sentiment will change, so we will remain patient. We have followed this same disciplined and consistent approach to managing capital since we began the firm in 1995. We will continue to follow this approach through all market conditions because we know that it produces the best results over the investment horizon.

PLEASE SEE IMPORTANT DISCLOSURES BELOW:

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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