Hutchinson
CAPITAL MANAGEMENT

October 2021

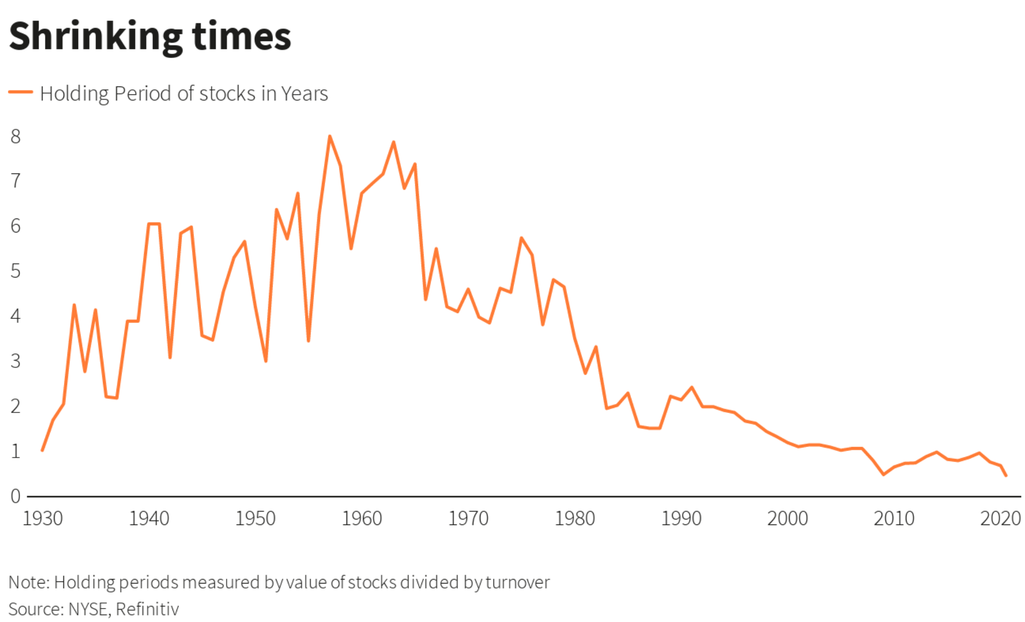
Patiently Optimistic

Something curious happened after the first COVID-19 shutdown. A new generation of investors using phone apps to trade more frequently drove unprofitable company stock prices on wild, gyrating rides. The volatile price action, which seems to be a byproduct of increased technology use, is also a result of the shorter attention spans of today's investors. Being quick and nimble can also have a positive impact. Investors can turn a quick profit and share those successes with friends, making them feel like smart investors. Short-term trading and short-term thinking are not new, but technology and social media are greatly accelerating these phenomena. The current market environment defines success for investors in increasingly shorter time horizons, and that has provoked the idea that we, as investors, must be constantly taking action. We feel there are sustainable advantages in the business of owning great businesses, but the most important, by far, is taking a long-term view. In this *Investment Perspectives*, we will discuss some of the cornerstones of our long-term investment approach.

Why do we focus on the long-term?

When we say short-term, what do we mean? In the investing world, it typically translates to increased trading. Does this work? Studies have shown that increased trading reduces returns over time. The other notable downside to this approach is taxes. By trading frequently, investors are more likely to be subject to short-term capital gains versus long-term capital gains. Short-term gains are taxed at ordinary income tax rates, which are typically much higher than long-term capital gains rates.

There is another more nuanced part of short-term trading that isn't discussed as frequently. Typically, but not always, there can be the belief that "smart" investors are nimble and jumping in and out based on their assessments of the current environment. They tend to talk about their wins and the fact that they "sold everything" miraculously before a big decline in the markets. This can lead more disciplined investors to question, "Should I be doing this too?" The chart below depicts how the average holding period for US stocks has declined steadily for the past several decades.



As of June 2020, the average holding period for U.S. Equities hit a record low of 5.5 months. It's likely this number has decreased further into 2021 due to heightened trading of 'meme' stocks and record inflows into the stock market.

While the average holding period for U.S. stocks is less than six months, by contrast, HCM's average holding period has been over four years since the firm's founding. When we think about investment management, we consistently remind ourselves of the adage, "Sometimes the best action is inaction." While we are always looking for short-term price dislocations to opportunistically deploy capital, we will never invest without a long-term thesis for doing so.

Beat or Miss

Public companies report earnings quarterly. These earnings are a large focus for the investing community as it's a chance for the public to hear how a company is doing in the current economic environment. It's an opportunity to hear their thoughts on factors within their control, i.e., new product launches, competition, and business reinvestment, but also factors largely out of their control, i.e., inflation and supply chain issues. Wall Street analysts spend copious amounts of time trying to estimate company earnings and whether they will "beat" or "miss" expectations, as these can lead to large fluctuations in the stock price within a single day. Some investors will decide to buy or sell a stock based on the information they gather from these calls or analyst ratings.

While we consistently listen to earnings calls, we tend to look and listen a bit differently. We have a long-term investment thesis with every company we own. Are they executing on that thesis? Are they investing in the business for long-term growth even though Wall Street may blame them for "missing" a short-term earnings target? Is management transparent about what they know and don't know? Management teams with all the answers are typically not sharing the whole story. We want to bring to your attention two recent examples in our portfolio that highlight how our reaction to material investment news may differ from the consensus.

CarMax is a nationwide used car dealer who revolutionized the used car buying process by offering a haggle-free experience. Most of the used car market is mom-and-pop style dealerships that create a highly fragmented market, giving CarMax a long runway for future growth. Recently, CarMax's stock declined following an earnings call with Wall Street analysts. They reported declining profit margins and analysts were primarily focused on the possibility of impacted profitability going forward. Our analysis of the same information turned up something very different. CarMax had taken very dramatic steps at the beginning of COVID-19 to cut expenses, including laying off more than half of its workforce, to prepare for a prolonged downturn as companies had very little insight into how the next several months would play out amid recession concerns. These cuts led to high profit margins in the short-term. We are now one year removed from those short-term inflated profit margins and Wall Street was predictably disappointed. In addition, CarMax chose to think long-term and reinvest in their business. Those items led to stock declining nearly 15%. We believe the company is making a wise choice to continue to build the business for the long-term.

Progressive is another recent opportunity where the market's short-term focus has impacted the stock and presented an opportunity to add to our position with a short-term drop in the stock price. Progressive is a car insurer with a unique business model, accompanied by very humorous commercials I'm sure you've seen. Progressive also made impressive profits during COVID-19 as people drove less and thus had fewer accidents. Now, with many more drivers back on the road, the company has paid out claims with increasing frequency. Wall Street bemoans their weaker profits in the short-term. We see an exciting opportunity to own more of a business that we believe will continue to gain market share for years to come.

Second-Level Thinking

In his book *The Most Important Thing*, Howard Marks, author and co-founder of asset management firm Oaktree Capital Management, explained a guiding principle to his investment philosophy:

> First-level thinking is simplistic and superficial, and just about everyone can do it (a bad sign for anything involving an attempt at superiority). All the first-level thinker needs is an opinion about the future, as in "The outlook for the company is favorable meaning the stock will go up." Second-level thinking is deep, complex, and convoluted. The second level thinker takes a great many things into account:
>
> - What is the range of likely future outcomes and which outcome do I think will occur?
> - How does the current price for the asset compare with the consensus view of the future, and with mine?
> - What will happen to the asset's price if the consensus turns out to be right, and what if I'm right?[1]

[1] Marks, Howard. *The Most Important Thing*. Columbia University Press, 2011.

Under first-level thinking, outcomes look similar because easy answers are driven by shared past experiences and beliefs. People reach the same conclusion, like when a company misses on earnings and the cause of the miss and subsequent sell-off seem to be in unanimous agreement. We try to own businesses that are not focused on the next three to five *months* but rather the next three to five *years* and invest in their business accordingly. Thinking in this manner requires discipline and the ability to think *through* time. Second-level thinkers often find themselves asking the question, "And then what?" It requires both the ability to arrive at an investment conclusion that differs from the consensus view and the ability to be comfortable with differing from the "conventional wisdom."

Conclusion

Our focus on the long-term can lead to short-term impacts on portfolio performance. The portfolio returns may lag the standard indices while some companies face short-term headwinds. However, we view these events through an optimistic lens, and they rarely impact our long-term outlook. Again, we are focused on the next three to five years, as opposed to three to five months. We realize viewing the world from a long-term perspective takes discipline, not only for us as investment managers but for you as clients. Patience is critical as we work to execute our investment strategy on your behalf.

We realize that there are many issues today that make investors fearful, and these fears range from unending debt and deficits, to the potential for runaway inflation. While strong businesses face difficulty predicting short-term crises, they do have an amazing ability to adjust to crises over the long run. These short-term events become incredible opportunities to buy stocks, rather than sell them. As Warren Buffet has liked to say, "My favorite holding period is forever." There is no greater satisfaction (at least here at HCM) than owning a company for decades and watching them successfully execute on a long-term business plan.

PLEASE SEE IMPORTANT DISCLOSURES BELOW:

As of September 30, 2021, Hutchinson Capital Management (HCM) held:

131,799 shares of CarMax, Inc. (KMX)
201,346 shares of The Progressive Corporation (PGR)

As of September 30, 2021 (Prices in USD unless noted otherwise)

CarMax, Inc. (KMX) closed at $127.96
The Progressive Corporation (PGR) closed at $90.39

As of September 30, 2021, the following were the ten largest holdings of HCM:

Name of Issuer	% of Equity Portfolio	09/30/2021 Closing Price
Bank of America Corp	7.13%	$42.45
Berkshire Hathaway Inc Class B	5.98%	$272.94
Apple Inc	5.72%	$141.50
Microsoft Corp	5.07%	$281.92
Capital One Financial Corp	5.04%	$161.97
Robert Half Intl	4.80%	$100.33
Markel Corp	4.67%	$1,195.13
Progressive Corp	4.42%	$90.39
Jacobs Engineering Group Inc	4.29%	$132.53
Carmax Inc	4.09%	$127.96

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.

Nothing herein should be construed as a solicitation or offer, or recommendation to buy or sell any security, or as an offer to provide advisory services in any jurisdiction in which such solicitation or offer would be unlawful under the securities laws of such jurisdiction. The material provided herein is for informational purposes only. Before engaging HCM, prospective clients are strongly urged to perform additional due diligence, to ask additional questions of HCM as they deem appropriate, and to discuss any prospective investment with their legal and tax advisers.