



July 2017

## INVESTMENT PERSPECTIVES

### *The Sin of Complacency*

*“Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria.” - Sir John Templeton*

When the current bull market finally breathes its last, we may have to amend Mr. Templeton’s famous quote to include, “...die on euphoria or *complacency*.” Current valuations would suggest that equity markets are in a state of euphoria. Having fresh memories of the last two euphoria-driven equity bubbles, we know what to look for. The S&P 500 is in its 100<sup>th</sup> month of a bull market--the second longest since 1926. Complacency easily takes root in a market environment which hasn’t undergone a 20% correction since 2009. Despite being nearly as expensive, this market feels different to us. While there’s no desperation to own stocks, there is a profound sense of complacency among investors as to what they own. For some there may be a certain solace in such detachment, but we remain committed to knowing what we own and vigilant in understanding what companies are worth.

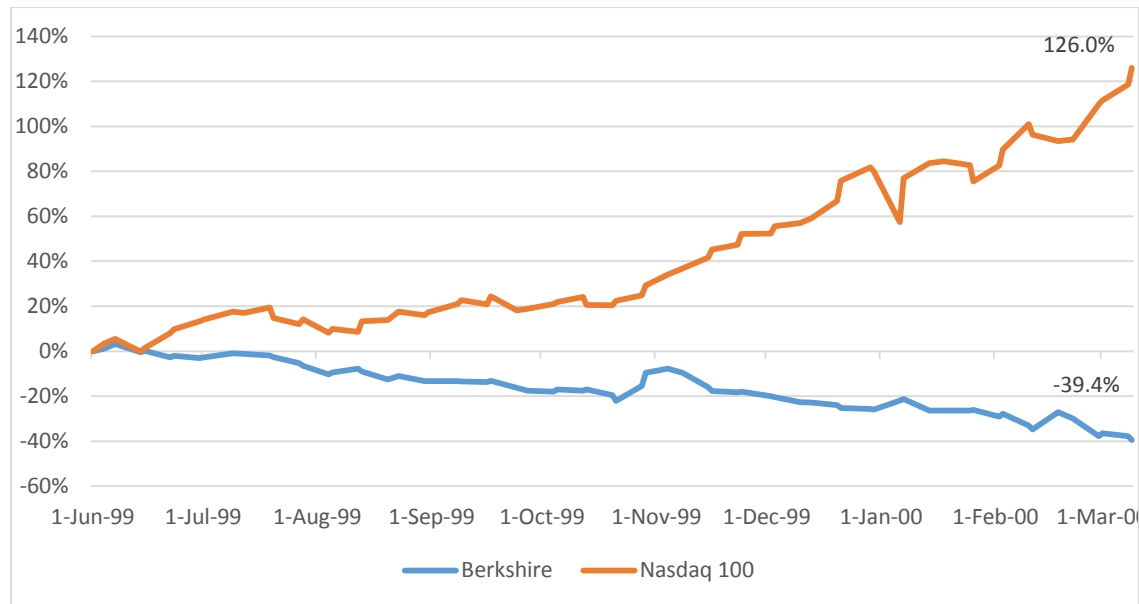
In this edition of our *Investment Perspectives* we will discuss some of the more poignant factors currently affecting the markets. The topics we have chosen stem from both our recent meetings with many of you, as well as from those issues dominating the headlines and impacting investor behavior. As always, we will endeavor to relate these issues to our own investment process and provide you with insight into how we adapt to an ever-changing environment in the stewardship of your wealth.

### **Glamour Stocks**

We are frequently asked why we don’t seem to own more exciting technology companies, the sort of companies one reads about in the headlines every day and that make the products we see and touch in our everyday lives. Our first response is to borrow a line from Nobel Laureate economist, Paul Samuelson who said, “Investing should be more like watching paint dry or watching grass grow. If you want excitement, take \$800 and go to Las Vegas.” Another answer might be that it is unlikely that we will find value in the stocks atop the market’s list of favorites. But answering this question more thoroughly allows us to delve into the important topic of *Process vs. Outcome*, which gets at the essence of how we make decisions.

Value investor, Warren Buffett, known to be friends with Amazon CEO Jeff Bezos, was recently asked why he didn’t own Amazon stock; his tongue-in-cheek answer was, “Stupidity.” He went on to clarify that, while the outcome would have been favorable, he could not have foreseen Amazon’s path to dominance. The investment merits of Amazon’s stock relied too heavily on future (unpredictable) growth, and therefore failed to pass the rigors of his investment process. What Mr. Buffett meant was that the end doesn’t always justify the means. Investing is a business with uncertain outcomes, particularly in the short-run. If Mr. Buffett had ignored his process and purchased Amazon anyway, it would have worked but not for reasons consistent with his long successful investment process. When investment managers succumb to pressure and buy stocks that don’t fit their investment process they are speculating, not investing. This is referred to as *Style Drift* and clients should always view such shifts as a red flag.

The last time value investors faced this sort of pressure was during the technology bubble of the late 1990's. We know that feels like a long time ago, but we are always grateful for lessons learned at the expense of others. This period saw billions of dollars in assets flee value investors. Capitulating in frustration, famed value manager Julian Robertson shuttered his multi-billion dollar fund rather than shift his investment style. Just as now, Mr. Buffett remained true to his process and stayed out of the fray. His absence did not come without cost. Just prior to the collapse of the tech bubble, the market was convinced that value investing was a dead art and its practitioners destined for the dustbin of history. Between June 1999 and March 2000, the growth-heavy NASDAQ 100 index rose 125% while Mr. Buffett's Berkshire Hathaway declined 40%!



Again, using history as our guide, let's explore the merits of buying the largest, fastest growing, and most popular stocks. Looking at 500 or so companies fitting these criteria over the past 60 years, there were some spectacular success stories. However, the overall results are not encouraging. Evaluating their performance over successive 10-year rolling periods, reveals that they underperform the market by nearly 4% per year. But what about the success stories? Of these 500 companies, exactly 10 survived and generated returns exceeding 15% per year.<sup>1</sup> Even though value investors may suffer periods of underperformance, the style endures as the best method of investing, in large part, by not overpaying for growth.

So, is there something about cutting-edge technology companies that makes them uninvestable using our long-established investment process? Is value investing simply out of touch with the modern economy? No, actually; our process does not disqualify companies based solely on the products they sell. Regardless of what it sells, a company must still adhere to the same basic laws of economics: owners inject fuel into the business, in the form of capital, which the managers convert into the energy of cash flow. Our process measures the efficiency of this cycle--how much capital does the enterprise need to sustain itself and grow. While we are not anti-growth, we are very discriminating about the cost of growth and the returns earned from the capital invested in its pursuit.

<sup>1</sup> John West and Amie Ko. "Rethinking Conventional Wisdom: Why NOT a Value Bias?" Research Affiliates Aug. 2016.

## Understanding Your Risks

The complacency we see in the markets today stems from an intricate web of interconnected factors saddling investors with risks we're not sure they appreciate. Passive investing<sup>2</sup> is the ultimate expression of complacency, and it's the current rage. Every market environment is different and this one is fascinating. We are accustomed to thinking of bubbles in terms of investor greed, irrational behavior driven by the Fear of Missing Out (FOMO). So, the idea that a bubble can be created through complacency is new and different. Indexes are rising, driven by an increasingly narrow group of glamorous growth stocks. Some of this results from genuine economic factors, but much of it stems from market structure, investor complacency, and good old-fashioned marketing.

The sheer size of today's glamour stocks and the influence they have on the indexes makes them hard to ignore. Collectively, the top five stocks by market cap in the S&P 500 represent 13% of the total index. Because of this heavy weighting, they have accounted for 40% of the 9% YTD S&P 500 return. Looked at another way, if you didn't own these "Fabulous 5" stocks, your return from owning the other 495 companies would have been only 5.4%. So what, you might ask. Our contrarian instincts force us to consider the adverse case. Individuals buying the S&P 500 might believe the investment risks are lessened by the breadth of owning little bits of 500 different companies; and while the market is going up and they complacently ignore the ever-increasing concentration, what happens to returns when the wind shifts and money begins flowing out of BOTH growth stocks and index funds? The table below details these relevant facts about the Fab 5 plus NetFlix.

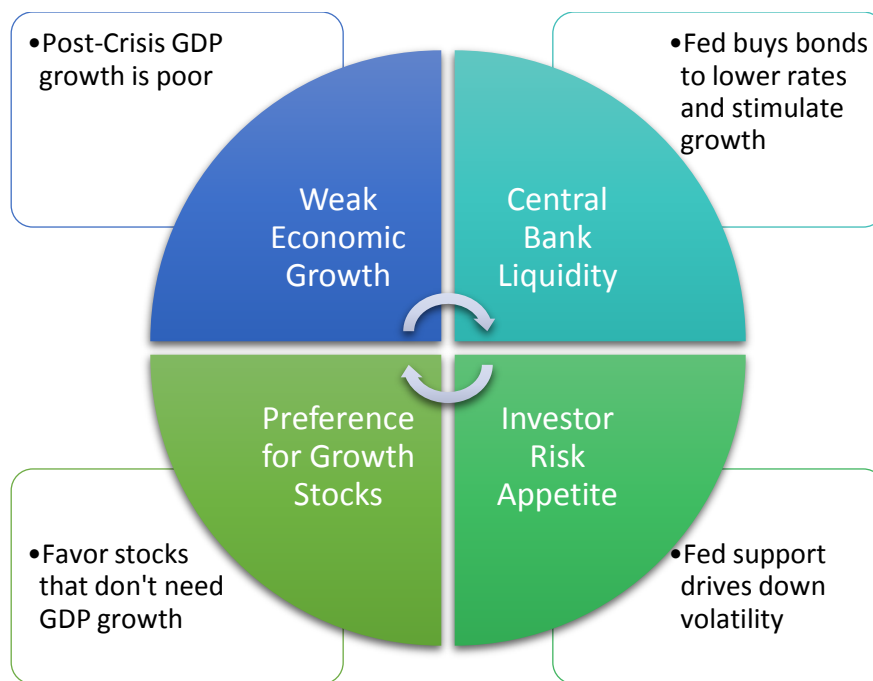
	Price	P/E Multiple	EPS Growth	Market Cap (\$Bln)	YTD Return	Weight in S&P 500
Apple	\$146	15.9x	12.7%	\$749.4	26.1%	4%
Google	\$961	28.6x	19.7%	\$648.6	21.2%	3%
Microsoft	\$70	25.6x	26.3%	\$534.3	12.2%	3%
Amazon	\$989	144.1x	52.2%	\$466.9	31.9%	2%
Facebook	\$153	33.4x	29.9%	\$436.4	33.1%	2%
NetFlix	\$154	193.0x	112.0%	\$65.1	24.0%	0.3%
S&P 500	\$2,441	19.3x	16.1%	\$18,735	9.0%	

We are not complacent and, unlike passive investors, we care about WHY our stocks go up and down. We always expect a good outcome, but it is our process of investing that receives the bulk of our attention. When investors grow complacent and don't care to know why they own something, only recent outcomes matter to them. Professional investors are certainly not immune to complacency and it's not only individuals that are crowding into index products. Due to the out-performance of the S&P 500 Index in 2017, and from 2009-2017, an increasing number of active managers have become "closet indexers," which essentially replicate the index assets while charging a higher fee.

*"A couple of decades ago there were essentially no 'closet index' funds. But as index investing has become more popular, individual investors have become 'more benchmark aware'. 'Your performance relative to the benchmark has become more salient.' As a result, investors are now quicker to bail out of funds if they fall short of their benchmark indexes, creating an incentive for managers to at least match their benchmarks -- and a disincentive to make big bets that could go wrong. In summary, the end result of this circular flow of capital is that the amount of "true" actively managed money today, is much less than it has been historically. Simply put, there is real career risk in being an active manager, and being significantly different than indexes. And, when everyone is crowded in the same trades, in the same stocks, perhaps that is the time to be different?"<sup>3</sup>*

<sup>2</sup> Passive investing describes the process of buying an index product or exchange traded fund (ETF) without concern for price, timing, or valuation.

<sup>3</sup> Martijn Cremers; "The Rise of the Closet Indexers." Yale University Press; March 1, 2011.



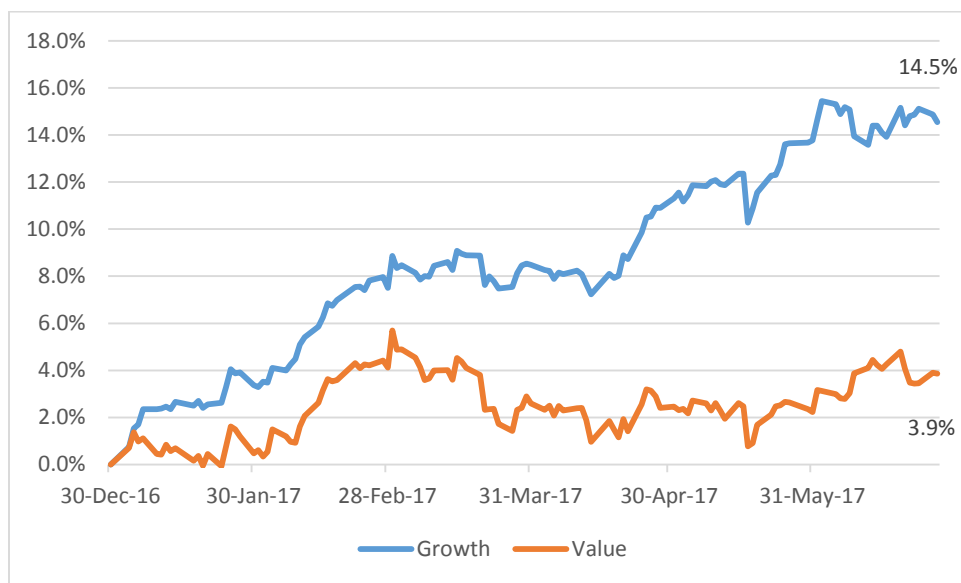
### Cause and Effect

The diagram above demonstrates the circularity that has resulted in the situation we now find ourselves. It began long ago with Fed Chairman Alan Greenspan. What eventually became known as “The Great Moderation,” commenced with Mr. Greenspan’s success using Federal Reserve liquidity to stem the effects of the 1987 stock market crash. Successive central bank victories using money to assuage fear, has now morphed into a grand experiment to remove the normal volatility of economic and market cycles. Many subsequent risks, real or imagined, have been met with Federal Reserve assistance in the form of lower rates or money injections. Some of these episodes included: The Long Term Capital failure, turn-of-the-century Y2K fear, the collapse of the technology bubble, and finally, the housing/credit bubble. Each episode of Fed intervention, and apparent success, emboldened investors as to the central bank’s omnipotence. This has reduced investors’ respect for risk, and led to successive waves of bubbles and busts. Which brings us to the current passive investing bubble: based on the notion that it doesn’t matter what you own or what you pay for it because the never-ending wave of liquidity will allow the next guy to pay more than you did. While the outcome thus far has been satisfactory, we believe the process is profoundly faulty. The Fed has achieved its goal of inflating asset values but this interference with the normal functioning economic system has left us with lethargic growth and asset values sitting atop an unstable foundation. Since the stock market bottom in 2009, the mix of factors driving the rise in prices are low quality (65% P/E multiple expansion, 20% from EPS growth, and 15% from dividends). We prefer to see stock prices rise because earnings are growing. Complacency in today’s market has fostered higher prices without commensurate earnings growth, leading to expanding Price-to-EPS multiples.

How is this linked to our current environment? Because the Fed’s effort to provide market stability takes money; money the government didn’t have but borrowed anyway. In aggregate, public sector debt has grown to obscene levels even when considered in the context of the fuel to repay it—the revenue of the aggregate economy (i.e. Gross Domestic Product or GDP). We believe the Fed was correct to add liquidity as a remedy to recover from the credit crisis. What we do not understand, and what we find very disturbing, is the fact that throughout our recovery over the past nine years, debt to GDP has grown to over 100%. This increase in debt has not driven the desired economic growth and has now reached a point where it’s hindering future growth. The influx of money did not go toward productive endeavors but rather it merely fueled inflation across nearly all assets. We know it hasn’t been effective because we have measured how much debt has been used to fuel GDP growth over time. In recent years, the federal government has been borrowing nearly \$5.00 to drive every \$1.00 of economic growth, a three-fold increase over the past 17 years. While these trends are troubling, and we believe the debt is impairing the ability of the overall economy to grow, we’re certain that our fellow citizens will find a creative solution to these problems. The United States has always proven itself incredibly innovative and resilient when

faced with meaningful threats, and we have every confidence that an answer we could not have foreseen will present itself. As we frequently remind you, we do not rely on our ability to forecast macroeconomic factors in the management of client portfolios. Our investment process depends upon our ability to find individual companies capable of generating high returns on capital regardless of the economic environment.

How does this affect our portfolio? In the fourth quarter of 2016, our stocks produced significant returns as investors responded to the prospect of higher real economic growth, infrastructure spending, lower regulations, lower corporate taxes, and less central bank interference. But this optimism quickly ran into the buzz saw of economic reality: our high debt levels now make it virtually impossible to stimulate growth through government infrastructure spending and lower taxes. The peak performance of our portfolio coincided, to the day, with the failure of Congress to enact healthcare reform. At that point, investors concluded that we would slide back into the morass of sluggish growth experienced over the previous nine years. Without the tailwind of aggregate economic growth, investors crowd into a select basket of companies exhibiting high idiosyncratic growth. This brings us full-circle to our current market environment. Cause and effect are easy to see: low economic growth prompts central bank intervention which lowers market volatility, raising investor risk appetite; higher risk appetite in the absence of improving fundamentals leads to rising prices via multiple expansion; rising prices with low volatility over a sustained period leads to complacency; complacent investors don't scrutinize what they own and just invest in the cheapest alternative requiring the least effort; non-discriminating buyers, ignorant or complacent of risk buy index funds; indexes, like the S&P 500 are market-cap weighted so the confluence of high asset flows into indexes and investor lust for growth stocks, conspire to drive indexes higher. So what, you might ask, it's worked hasn't it?



### **You Can't Argue with the Results**

Psychologists have long documented a tendency known as outcome bias. That is the habit of judging a decision differently depending upon its outcome. For instance, if a doctor performs a risky operation and the patient survives, the decision is rated as significantly better than if it had resulted in death. Of course the correctness of the doctor's decision should not be a function of outcome since the doctor couldn't have known the outcome before the event. The recent run of favorable returns earned by passive investors is an example of a good outcome despite a bad process. Consider the game of blackjack, which is one involving a mix of skill and luck. Imagine a player has drawn several hands totaling 17. On each occasion, the player opted to take another card, and each time he managed to draw a 4. Now, faced with a hand containing a 7 and a 10, despite having received 4's on each of the previous hands, the player's odds of getting a 4 on this hand can never be higher than 7.7% and his odds of busting altogether will always be 69%. The fact that his good luck allowed for a favorable outcome previously, should have no bearing on his decision whether to ask for another card. The skill of the game is knowing the odds involved in each decision--the cards that come up reflect only luck.

Investing involves a mix of skill and luck as well, and when an endeavor involves measures of each, it is best to consider skill in terms of process rather than just outcome. Patience, persistence, and resilience are all elements of skill. When skill exerts a greater influence, cause and effect are clearly connected. An investor or corporate executive who makes a good decision may suffer poor outcomes in the short run simply due to bad luck. Investing's mix of skill and luck means a good process will work but only over time--cause and effect are only loosely connected in the short run. Tasks like playing chess are said to be stable or linear: the board is always the same 64 squares, 8 x 8, the pieces always move the same way. The feedback between process and outcome is immediate and obvious: when you make a mistake, your pieces are removed from the board. Mistakes made yesterday should not be repeated tomorrow. History is useful, as is practice.

The stock market is neither stable nor linear. It is what we call a complex adaptive system. Prices move for both fundamental as well as random reasons. The feedback is looped not linear; actions of the participants can and do impact the overall system. Money flowing into indexes causes the largest stocks to move the most which in turn increases the concentration, making it easier to push the index itself higher. The run of favorable returns earned by passive investors since the financial crisis is an example of a bad process enjoying a favorable outcome. What's unusual about this market is just how long it's been going on; it is this duration that is fueling the complacency.

### **Conclusion**

Winning over the long term is an endeavor in which luck plays a part in the short run. Success depends upon having rules and a process which you know works. The skillful elements of this process are comprised of three parts: analysis, psychology, and the culture of the organization. A successful investment manager must have a culture and a client base that allows for episodes of bad luck in the execution of its proven, sound, long-term decision-making process. Without this fundamental core, the manager may find himself making decisions that protect his career before those that best promote long-term risk-adjusted returns. Such career risk stems from a fear of straying too far from convention and the trend toward conformity among investment managers is obvious. That conformity means creating a portfolio which looks a lot like the benchmark index. Crowding into indexes and similar mimicry is creating unappreciated risks. A simple way to evaluate our motives at HCM is to observe that we invest all of our firm's retirement assets in the same securities as our clients.

At HCM, we've institutionalized a decision-making framework which fits the culture of our organization and serves the best interests of our clients. We have developed an expertise that blends analysis and intuition; we use checklists that keep us focused on proper decision-making. We have a culture and client base that keeps the long-term goal in sight without succumbing to the distractions that may arise when our nonconformist investment strategy faces adversity.

We are patient, which is not the same thing as complacent. We carefully monitor the valuations of each company in the portfolio, selling when prices stretch too far above intrinsic value, and adding when they drop too far below. Our process is a mix of art and science. And while we aren't always right, we are always disciplined in adherence to our process.<sup>4</sup>

---

<sup>4</sup> Much of the inspiration as well as data used in this work originated from two excellent books written by authors whose work we appreciate and admire:

Mauboussin, Michael J.; *The Success Equation*; 2012, Harvard University Press, 60 Harvard Way, Boston, MA 02163  
Montier, James; *Value Investing*; 2009, John Wiley & Sons, The Atrium, Southern Gate, West Sussex, PO19 8SQ, UK

PLEASE SEE IMPORTANT DISCLOSURES BELOW:

As of June 30, 2017, Hutchinson Capital Management (HCM) held:

8580 shares of Apple (AAPL)  
162 shares of Alphabet Class A (GOOGL)  
10 shares of Alphabet Class C (GOOG)  
169144 shares of Microsoft (MSFT)  
60 shares of Amazon (AMZN)  
700 shares of Facebook (FB)  
0 shares of Netflix (NFLX)

As of June 30, 2017:

Apple (AAPL) closed at \$144.02  
Alphabet Class A (GOOGL) closed at \$929.68  
Alphabet Class C (GOOG) closed at \$908.73  
Microsoft (MSFT) closed at \$68.93  
Amazon (AMZN) closed at \$968.00  
Facebook (FB) closed at \$150.98  
Netflix (NFLX) closed at \$149.41

As of June 30, 2017, the following were the ten largest holdings of HCM:

Name of Issuer	% of Equity Portfolio	6/30/2017 Closing Price
CARNIVAL CORPORATION	6.4%	65.57
ROBERT HALF INTERNATIONAL INC	6.0%	47.93
NOVO-NORDISK A S ADR	5.8%	42.89
WELLS FARGO & CO	5.6%	55.41
JOHNSON CONTROLS INC	5.1%	43.36
INTEL CORPORATION	4.9%	33.74
NATIONAL OIL WELL VARCO	4.9%	32.94
MERCK & CO. INC.	4.7%	64.09
MOSAIC CO NEW COM	4.6%	22.83
JACOBS ENGINEERING GR	4.6%	54.39

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.