



January 2018

INVESTMENT PERSPECTIVES “Of Fairy Tales and Financial Markets”

Financial journalists are fond of using fictional references, particularly fairy tales, to humanize the complex concepts surrounding financial markets. From Cinderella Stories to Emperors with No Clothes, we at Hutchinson Capital Management (HCM) are also fond of fairy tale metaphors. After a terrific 2017, one with good growth and low inflation, Goldilocks is a popular prop in financial prose. In this Investment Perspectives, we will discuss these “just right” economic and market conditions that have delivered superb returns with little apparent risk. We do appreciate the use of Goldilocks, but after several years of such conditions, we are facing precarious asset valuations. So, perhaps a more suitable moral parable for markets today is The Three Little Pigs.

Goldilocks conditions of solid growth with little inflation have prompted inflation across nearly every financial asset class. In fact, one brokerage report dubbed the current environment “A Bull Market in Everything.” We are witnessing the longest bull market for balanced portfolios¹ in over a century. Since Federal Reserve officials don’t lower themselves to using childish story references, they prefer the term *Great Moderation* for conveying such Goldilocks conditions in the global economy.

In the stories, Goldilocks was a sweet, if naïve character. While she escaped unscathed in her tale, such was not the case for two of our three Little Pigs. The two naïve and lazy pigs lost everything, having to beg generosity from their more diligent brother. As we look around financial markets today, we see a similar disregard for diligence that has left us with an environment of carefree risk-taking. A long episode of Quantitative Easing (QE) and negative interest rates has raised complacency and lowered the incentive to delever balance sheets. Massive money flows into financial markets have prompted indiscriminate buying of financial assets and an utter disregard for risk.

- Corporate debt in the US has risen to over \$6 trillion
- Nearly 50% of sovereign debt outstanding yields less than 1%
- The S&P 500 has posted its longest stretch since WW II without a 20% price correction
- US 10-year bond yields are at 145-year lows; last this low in the 1940s after the Great Depression
- Schiller P/E ratios² are the highest since the roaring ‘20s and the 1990s tech bubble
- Investment grade credit spreads are the narrowest in 100 years³
- Historic low return dispersion⁴

¹ Throughout this paper, we use the term *Balanced Portfolio* to mean a generic portfolio consisting of 60% stocks and 40% bonds.

² The Schiller Price/Earnings Ratio is the stock’s price divided by the average of the last 10 years of earnings per share. This calculation smooths out the volatility of the economic/business cycle effects on a company’s EPS.

³ A credit spread is the yield differential between an individual bond and a risk free government bond; it is a measure of investor concern over a company’s credit quality—the wider the spread, the more premium investors demand to accept the risk of the company’s credit.

⁴ Return dispersion is the difference in returns between the top performing stocks and worst performing stocks; it depicts the degree to which investors differentiate between companies. It is an important indicator of the value of

Despite these uncertainties, we are satisfied with how we managed portfolios in 2017, and are preparing for a 2018 that is bound to be vastly different. The great performance of assets for the past nine years has not lulled us into a state of complacency; nor do the risks freeze us in fear. Like Little Piggy number three, we favor preparation over paranoia. With this in mind, our primary goal of preserving investor capital is always paramount in our preparation process. We are absolute return investors, but we also pay attention to how our investment choices differ from the average investor. We select individual stocks from the bottom-up, based on their fundamental merits, but this still results in an active decision to commit more or less capital to individual sectors and industries. We manage risk by capping our allocations to any one sector; we go one step further by evaluating the factors which influence the fundamentals of our companies regardless of the sector in which they are designated. For instance, Now, Inc. (DNO) is classified by S&P as an Industrial company but its fundamentals are driven almost exclusively by investment spending from Energy companies, so it acts like an Energy stock. Relative to the benchmark index, the most significant sector allocation decisions helping and hurting our performance in 2017 include:

- **Energy:** Overweight by 3.5 percentage points; contribution to returns +0.79%
- **Consumer Discretionary:** Overweight by 4.5 percentage points; contribution to returns +0.45%
- **Health Care:** Underweight by 3.5 percentage points; contribution to returns -0.24%
- **Materials:** Overweight by 4.5 percentage points; contribution to returns -0.37%
- **Financials:** Underweight by 1.0 percentage point; contribution to returns -0.38%
- **Consumer Staples:** Underweight by 5 percentage points; contribution to returns -1.40%
- **Industrials:** Overweight by 7.5 percentage points; contribution to returns -2.0%
- **Information Technology:** Underweight by 14.5 percentage points; contribution to returns -5.7%

At HCM, we find it more useful to analyze our shortcomings in order to learn from them rather than to congratulate ourselves on our successes. Pointing that lens on the list of return contributions above, we spent our efforts understanding the factors behind our misses in Consumer Staples, Industrials, and Information Technology. IT stocks account for 24% of the S&P 500, but our allocation was around 9.5%. Even though the returns on the Tech stocks in our portfolio were comparable to those in the S&P, our sector underweighting hurt our relative returns by 5.7 percentage points. 40% of the 19% price rise in the S&P over 2017 was driven by technology stocks. We limit our exposure in any one sector to ~20%, so we would never hold as large a weighting in Tech as the S&P; that said we could have owned more than 9.5% if we had found any value opportunities in the sector. Within Industrials, we were overweight by 7.5 percentage points and our stocks underperformed; this cost our portfolios 2%. In Consumer Staples, we were underweight by 5 percentage points and our stocks underperformed, costing us 1.4%; in this case, being underweight helped us.

The detail underlying the underperformance include three commodity-cyclical stocks, impacted by weak commodity prices and two stocks with idiosyncratic issues. Now, Inc. (DNO), National Oilwell Varco (NOV), and Mosaic Company (MOS), were impacted by weak oil and agricultural crop prices. Johnson Controls (JCI), lowered its near-term free cash flow forecasts. CVS Health (CVS), was impacted by fears of competition from Amazon and the investor uncertainty created by the announcement of the \$66 billion acquisition of Aetna Healthcare. But, as we write this, crude oil is hitting three-year highs, while exploration companies have underspent by trillions of dollars. This pent-up demand will eventually benefit our stocks that are sensitive to Energy. We've just had our fourth consecutive season of robust crops in the US, a highly unusual occurrence; this has left agricultural soil severely depleted and needing the kind of nutrients provided by Mosaic. Additionally, the tax reform bill is expected to have a disproportionately favorable impact on farmer income, thus improving their ability to pay for fertilizers. In several cases, we used downside volatility to add to underperforming positions offering compelling value; in this way, we both increase our exposure to solid companies while also lowering our cost basis.

stock selection. When return dispersion is low, it means investors are not discriminating between individual company characteristics.

As active managers, we constantly monitor our portfolio for risks and opportunities. This means replacing stocks that aren't worthy to remain in the portfolio, harvesting profits from our stocks with extended valuations, or adding to positions trading too cheaply to fundamental value. In cases where our stocks have meaningfully underperformed, we always reevaluate our investment thesis to search for flaws in our analysis. If something changes and we turn out to be wrong, we reduce or eliminate our exposure. If our thesis is still valid, but the stock is merely the victim of adverse volatility, we may buy more. This was the case with DNOW; the stock declined sharply just as the fundamentals began to improve, prompting us to add to the position. We always seek to have our best performing stock be our largest holding, and we achieved that in 2017. In that vein, we always compare the sizing of our best-performing stocks to our worst performers. In 2017, our top five performers amounted to more than 25% of our portfolio while our five worst performers were less than 18%.

Top 5 Performers			Bottom 5 Performers		
	Weight	Return		Weight	Return
	7.0%	54.0%		2.5%	-5.5%
	5.5%	31.5%		4.0%	-5.6%
	5.0%	31.0%		4.8%	-5.0%
	4.8%	25.5%		5.0%	-11.0%
	3.5%	36.5%		1.8%	-46.0%
Average	5.2%	35.7%	Average	3.6%	-14.6%
Median		31.5%	Median		-5.6%
Portfolio Contribution		9.6%	Portfolio Contribution		-2.0%

In total, our top five performers added 9.6% to our return, while our bottom five took away only 2%. We also hold a certain amount of cash which, in upward trending markets like we've seen over the past few years, reduces our relative returns. Despite its drag on returns, we hold cash for its optionality—the ability to take advantage of market downturns to add to existing positions or buy new stocks that suit us.

The 'Bull Market in Everything' has pushed valuations in equities, bonds, and credit to the 90th percentile of historical averages, the highest ever. We're not calling for a bear market, but we are wary of the lack of shock absorption in financial assets. Equities were more expensive during the 1990s Tech bubble, but bonds were relatively cheap back then. When markets declined after that bubble burst, our equities were not completely immune, but our balanced portfolio was shielded by our bond holdings. Unlike 1999, we enter 2018 with a bond market that is also very expensive. The longer this period of low interest rates has persisted, the greater the desperation investors have felt to capture yield. This explains how 50% of currently outstanding sovereign debt yields less than 1%. It's doubtful that many investors consider 1% to be a good return. With inflation expected to reach nearly 2% in 2018, asset values on trillions of dollars of outstanding debt are at risk. As the table below indicates, over the past 100 years, stocks have been more expensive than today only 11% of the time and bonds 18%.

Valuation frustration - both bonds and equities appear expensive

Valuation percentile (since 1871 for S&P 500 & US 10-year yields, 1919 for BAA spreads)

	Metric	Current	Historical %ile	Median
Equity (S&P 500)	EV / Sales	2.4 x	97 %	89%
	Forward P/E	18.6 x	90	
	Cyclically adjusted P/E (CAPE)	27.6 x	90	
	EV / EBITDA	11.9 x	89	
	Cash flow yield (CFO)	6.9 %	88	
	Price / Book	3.4 x	88	
	Free cash flow yield (FCF)	4.1 %	56	
Rates	Nominal 10-year Treasury	2.4 %	85	82%
	Real 10-year Treasury	0.5 %	76	
Credit	High Yield YTM	6.2 %	94	
	Investment Grade YTM	3.3 %	82	
	High Yield Spread	358 bp	81	
	Investment Grade Spread	98 bp	78	

Source: FactSet, Compustat, Haver, and Goldman Sachs Global Investment Research. As of December 31, 2017.

The Two Little Pigs

If this overvaluation is so obvious, who is buying financial assets? Over the past six years, a total of \$1.1 trillion has flowed into US equities, and the primary buyers of those stocks are insensitive to price or valuation. \$3.2 trillion has been purchased by corporations through share buybacks, and ETFs have bought an additional \$1.3 trillion. The primary sellers have been pension funds, households, and foreign investors. Among those foreign investors have been Middle Eastern sellers who, in response to lower oil prices, have sold \$400 billion of US equities to raise cash. The indiscriminate buying has made individual stock selection more difficult, partly explaining why, over the past 10 years, only 34% of large-cap mutual funds have outperformed the S&P 500.

Strong stock returns have not occurred in the absence of decent fundamentals. Earnings growth has been decent throughout this market cycle despite weak top line growth. Companies have achieved this in part through share buybacks. Buybacks work to raise EPS while also putting a floor under share prices, further dampening volatility.

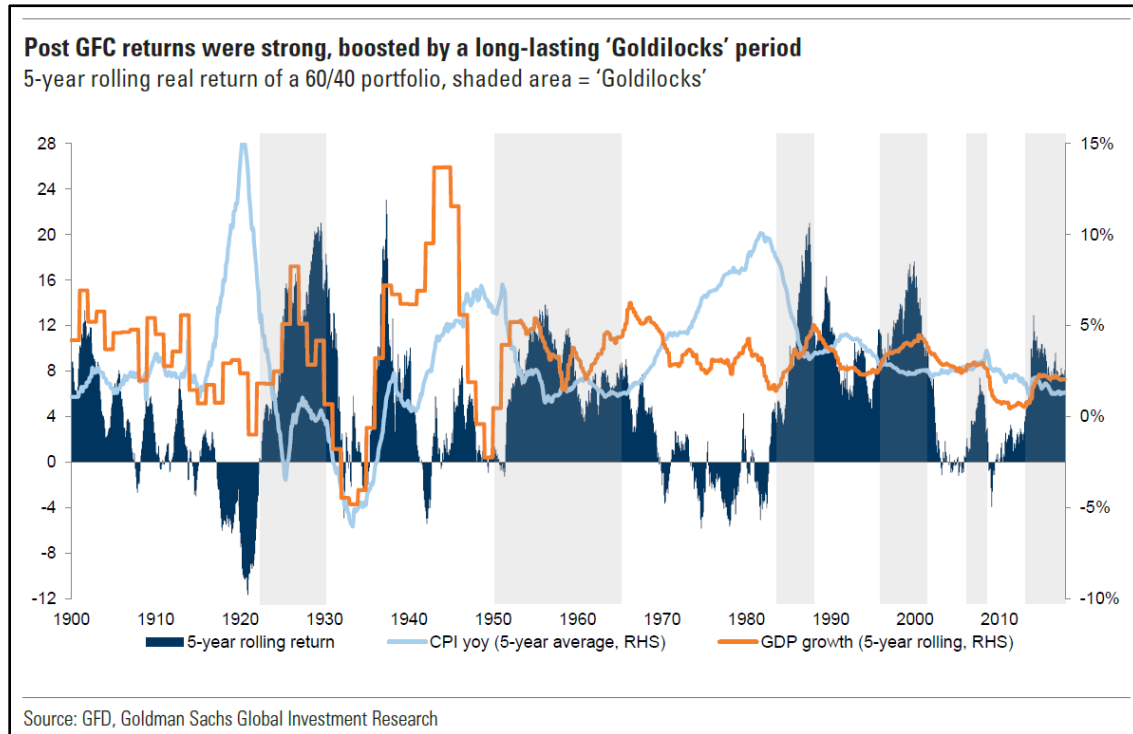
Since 1900, real returns from balanced portfolios have been close to 5%. This is understandable considering the long run average real yields have been 5%. But Goldilocks has fueled extraordinary returns for balanced portfolios since the 1990s. Average returns over the past nine years have been 11% p.a.; since 1985, 7.1%; over the last 100 years 4.8%. Current market expectations for returns are only 2.2%⁵, though our numbers suggest something closer to 4%. 5.2%⁶ from equities, and 1.8% from bonds.

Expected return should always be considered relative to the risk involved. When we evaluate market risk, we use a calculation called the *Equity Risk Premium* (ERP) to gauge the attractiveness of stocks relative to bonds. The premium at which an asset trades above that risk-free rate is a measure of the market's perception of the riskiness of the investment. ERP is a long-run prediction of how much the stock market will outperform risk-free bonds. A higher ERP suggests that more money should be allocated to equities relative to bonds. Since ERP cannot be measured directly, it serves merely as an indicator or signpost of risk vs. opportunity. Long-term investors, like Warren Buffett have opined that a proper Equity Risk

⁵ Thomson Reuters market survey; December 15, 2017.

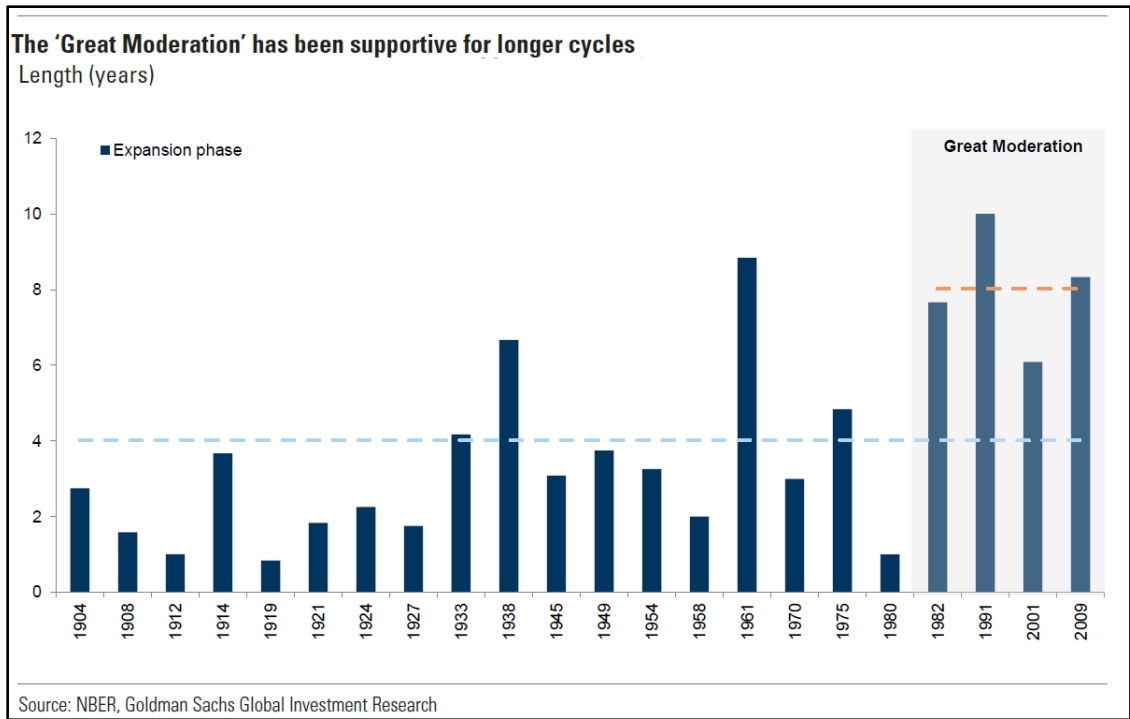
⁶ We use a ratio called the Earnings Yield, which is simply the P/E multiple inverted. We assume \$150 of EPS for the S&P 500 and a year-end target of 2850 which results in an expected return of 5.2% (\$150/2850).

Premium is ~7%. Our calculation of the current ERP is 4.7%⁷, below Buffett’s margin of safety but still cheap relative to bonds. We are cautious about this calculation in the current environment of artificially low bond yields. A sudden “reset” of bond yields due to a bout of unexpected inflation or more rapid rate normalization by the Federal Reserve, would have significant, adverse effects on the relative attractiveness of equities.

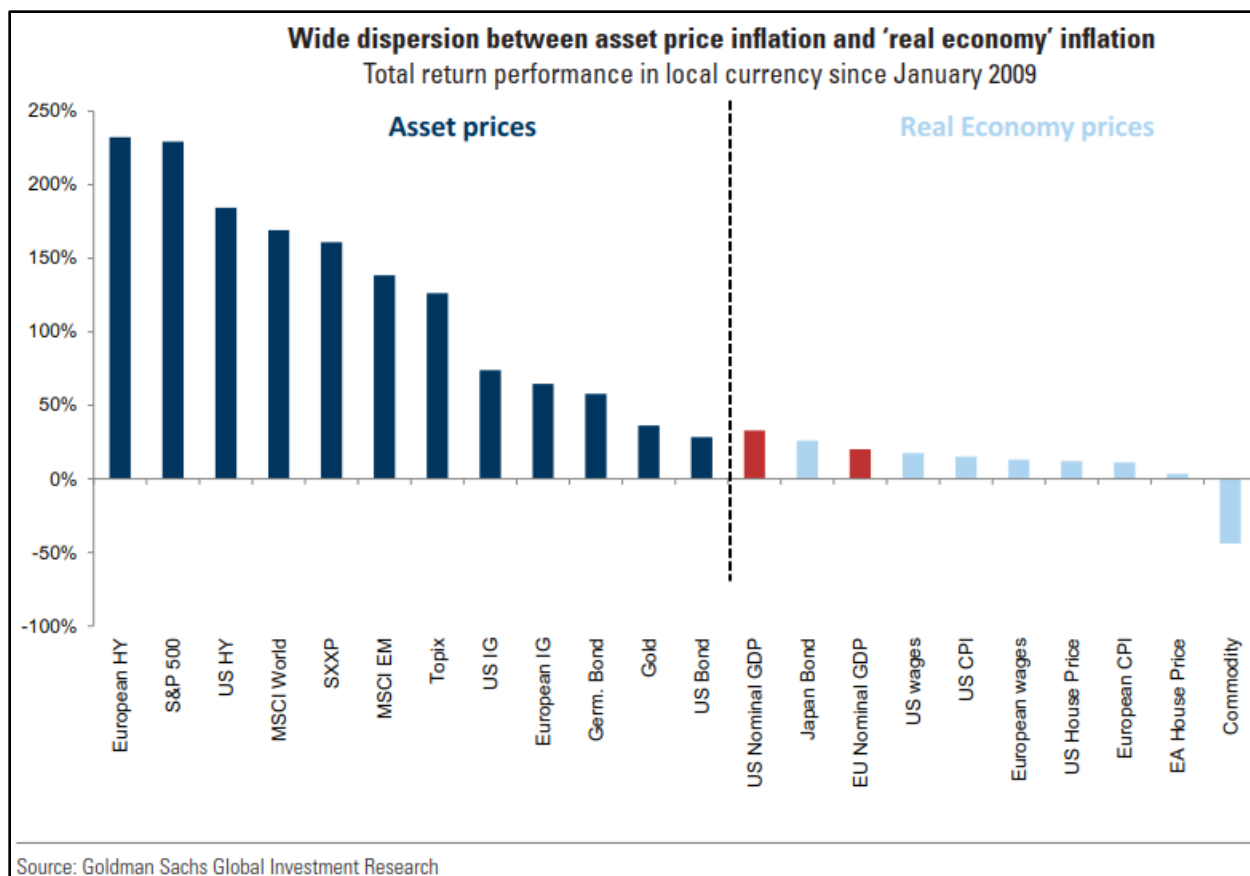


The length of any particular cycle affects investor perception and, in the case of current markets, presents risks perhaps not appreciated by many investors. As we discussed in an earlier Investment Perspectives covering complacency, the length of this Great Moderation and low volatility period has lulled investors into a false sense of security. While low volatility periods are not uncommon, the conditions we have experienced over the past nine years are not the norm. The financial press is littered with references to low volatility, and they struggle to explain its persistence in this cycle. As such, we will try to bring some clarity to this abstract concept and shed some light on how it affects the way we think and invest.

⁷ ERP (=) Expected return on equities (-) Real Bond Yields [Nominal yield (-) Inflation]; 5.2% (-) 0.50% (=) 4.7%; we use the 10yr TIPs yield to approximate the real bond yield.



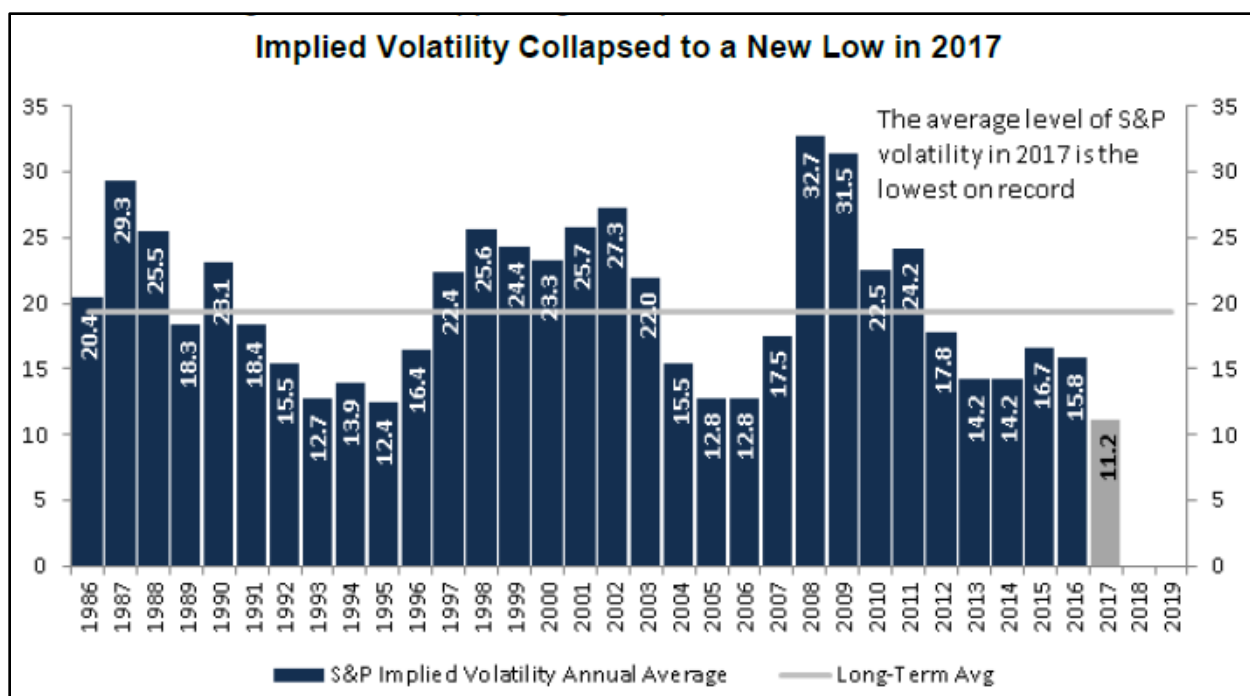
Among the few assets yet to participate in the 'Bull Market in Everything' is commodities. We have found some attractive opportunities among stocks related to depressed commodities, and we continue to evaluate others. As a general rule, commodities do better as the business cycle matures; they also do well during most rate hiking cycles. Inflation is always a risk to financial asset valuations when it surprises the market, but commodities offer refuge in such environments. Gradual inflation or reflation is favorable. Our portfolio is geared toward companies with real assets that will outperform when the real economy starts growing above trend. When we eventually get reflation in the economy, our asset-heavy companies will have the pricing power to offset rising labor costs that come with wage inflation. Right now, US core inflation is 40 basis points below the postwar average, and this has supported the suppression of volatility. The Fed achieved its goal of lowering volatility, but it came at the cost of lower growth. Central banks and other regulators sought to lower financial-system leverage and risk by raising bank capital requirements, intensifying regulations, and instituting stress tests. These measures have caused banks to shelter trillions of surplus dollars on their balance sheets while lending only to their most credit-worthy customers. The weak economy-wide top-line growth has diminished demand for commercial & industrial loans from corporations. This growth suppression lowered volatility in financial assets but also the volatility of macro variables: Inflation, GDP growth, and unemployment.



Low Volatility ≠ Low Risk

We don't think about volatility in the same way as most market participants. Value investors with longer-term buy and hold strategies welcome volatility rather than fear it. Price volatility presents opportunities to buy assets cheaply and sell when overpriced. Volatility affects most investors who trade actively or who know they need a certain amount of cash flow from their securities portfolio; if they suffer a meaningful decline in price, they may not be able to meet their obligations. Higher volatility of returns, while saving for retirement, results in a wider distribution of possible final portfolio values; for retirees, higher volatility of returns increases the risk that withdrawals (necessary or mandatory) will be made at a point of low portfolio value, thus impacting the ability of the asset base to grow in the future.

One way to think about how volatility moves up and down it is to compare it to the price of an insurance policy. When sellers of insurance believe that the cost or probability of having to pay a claim is rising, they will raise the cost of premiums to insure that asset. Volatility in the financial markets works similarly; even though volatility measures price movement both upwards and downwards, most investors are concerned with downside volatility. As a general rule, when volatility is rising, it's an expression of investor uncertainty, and because human beings fear loss to a greater degree than they covet gains, higher volatility can signal investor concern about future stock price declines.



Source: EvercoreISI

In general terms, risk is a critical variable in the price of all assets and is profoundly impacted by volatility. The Federal Reserve understood this when they began helping the markets recover from the 2008 Global Financial Crisis (GFC). The Fed used to keep the market on its toes—raising rates sporadically without notice. This kept bond investors wary and built a small cushion of respect for risk. Today, the Fed telegraphs its policy intentions in order to avoid surprise—to pull risk premiums out of the market. This forward guidance reduces interest rate volatility and thus term premium, creating flat yield curves. The Fed wants to foster risk appetite, and low interest rates inspire risk taking through increased leverage; companies and investors can take on more debt when interest expenses are low. Long episodes of low volatility further inspires risk taking, as borrowers feel safer when asset prices are stable. Additionally, when asset prices are rising, adding leverage enhances returns. But debt is a tricky thing—it’s easy to take on when markets are favorable, with rates low and stable, but when uncertainty rises, volatility increases with fear, and reducing debt becomes more difficult.

Periods of unusually low volatility are not new, and when volatility is very low, as it is now, it tends to stay low in the subsequent 12 months. Since 1928, there have been 14 low volatility periods for the S&P 500 and they lasted 22 months on average. Because periods of low stock price volatility are closely linked to the business cycle, they have generally occurred during periods with similar macro backdrops (Goldilocks). Low unemployment rates anchor equity and interest rate volatility; when unemployment rates begin to rise, it sometimes portends recession risk, and volatility begins to rise. Gradually rising volatility that reaches high levels, signals the risk of a market drawdown. We don’t trade volatility or use it in our valuation models, but we do pay attention to its value as an indication of the market’s appetite for risk taking. The *Volatility Paradox*, for instance, is the notion that extended periods of abnormally low volatility results in excessive risk-taking, making the financial system more fragile and susceptible to crisis. In our analytical process, we believe that the volatility of a stock’s market price should align with the basic fundamentals of its business (growth of revenue, cash flow, and EPS, etc.). We like finding companies with high stock price volatility (equity beta), but low financial volatility (asset beta).

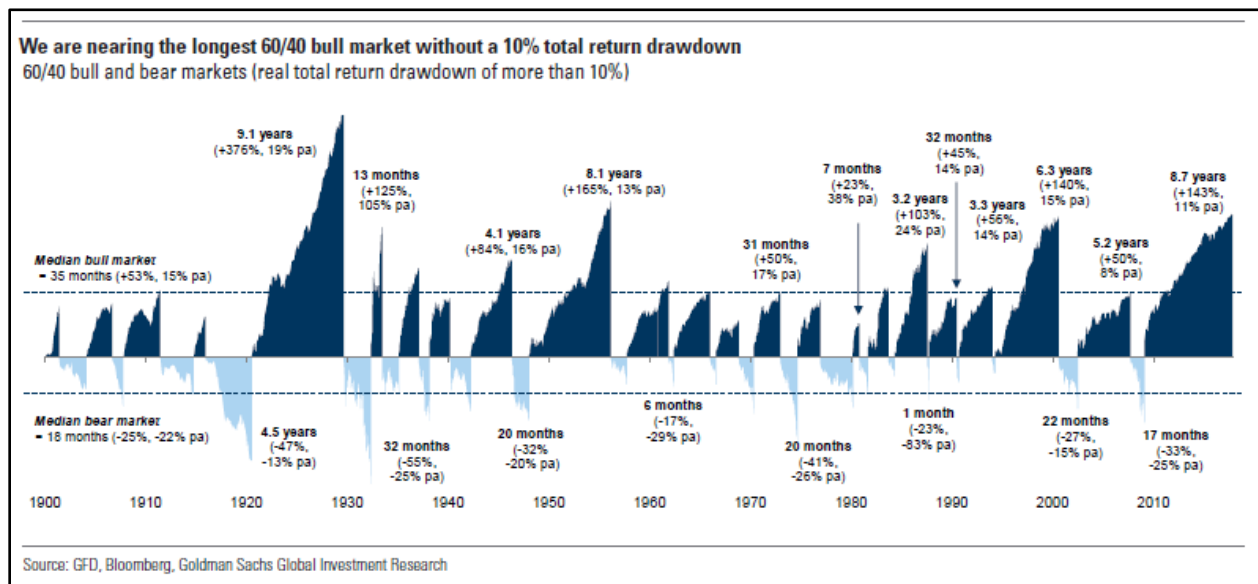
Measuring Risk

We agree with the predominant view that the greatest risk to asset valuations is central bank policy error. We believe the US Federal Reserve waited way too long to begin the rate normalization process, and they moved too slowly. Now they are raising rates in a game of catch-up rather than as a response to

overheated financial conditions. The unusually long period of low inflation and low interest rates has pushed yields down and forced investors to chase risk just to attain some modest return. This extended period of low volatility and easy returns formed this ‘Bull Market in Everything,’ and financial firms have responded by creating thousands of derivative securities that have dubious investment merit and risks that most investors can’t define.

How do we reconcile the bullishness of equity investors who are paying near-record valuation multiples for stocks, showing scant concern for risk, with bond investors who are buying long-term bonds like the economy will never grow again? Bond investors would say that we are late in the business cycle and bond term premia⁸ always decline at this point; investors buy long-term bonds most aggressively when they have limited fear of inflation. Inflation lowers the present value of future cash flows, so when investors aren’t worried about it, they are more willing to buy bonds that don’t mature until way out in the future.

- Over the past 100 years, equities, bonds, and credit have all been this expensive at the same time only twice; that was the roaring 20s in the Golden 50s
- After eight years, the pendulum has begun to swing the other way: growth is slowing, inflation is rising, and QE is reversing
- S&P 500 forward P/E ratio is 19x vs. a 10-year median of 14x
- S&P 500 EPS growth was 10% in 2017, is expected to be 14% in 2018, but slow to 5% in 2019
- 60/40 portfolios have not suffered a 10% drawdown since the GFC (nine years) - the longest ever



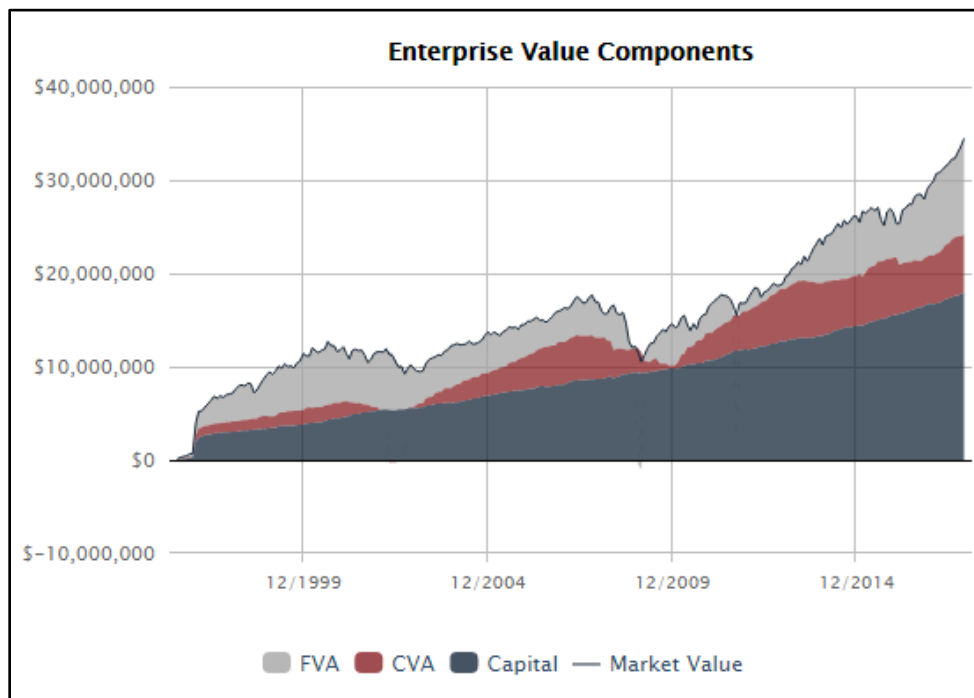
We most closely identify with the Third Little Pig. It is his dedication to preparation over paranoia that sits so well with us. We analyze our portfolio forensically, in great detail and we are keenly aware of our strengths and weaknesses. Even though we do not time the market, there is a very good reason why we pay attention to market-level risks. But like our favorite Little Pig, we seek to prepare for adversity constructively without paranoia. Such preparation requires work of both a practical and an emotional nature; this means building a bit of cash when opportunities are sparse and maintaining a list of stocks we like at lower prices with the intention of deploying that cash opportunistically. It also means that we must be emotionally prepared to ride out a market decline and accept the downside volatility while awaiting a more advantageous buying opportunity. At market bottoms, when investors are selling good companies alongside bad, we must be prepared to step in and be contrarian. These are the periods during which value investors are expected to make the bulk of their returns, but even though we are mentally prepared, it’s

⁸ Bond Term Premium refers to the difference between long-term interest rates and short-term rates; when the economy is weakening or in recession the difference between long rates and short declines—another description of this concept is to say that the yield curve is flattening.

never easy to step in and buy amid panicked selling. Mental preparedness means reviewing history and studying past market cycles to gain perspective and put brackets around the magnitude of potential drawdowns. Such drawdowns can occur swiftly or gradually. Over the past 100 years, when drawdowns have been swift, 60/40 portfolios declined (on average) 46% over 19 months. Once they bottom, it generally takes two years to recover.

If the overvaluation of the equity market is so obvious, why don't we just act on it? The answer is that we do not market time because valuations have a very mixed track record of predicting future returns. They do, however, highlight risk. In the past, when valuations (Schiller P/Es) have been this high, the subsequent range of five-year returns have been so wide as to be useless predictors of future action:

- They range from up 10.5% to down 15% per year
- The best time to buy stocks occurs when Schiller P/Es are below 10x; five years after which they have never been negative



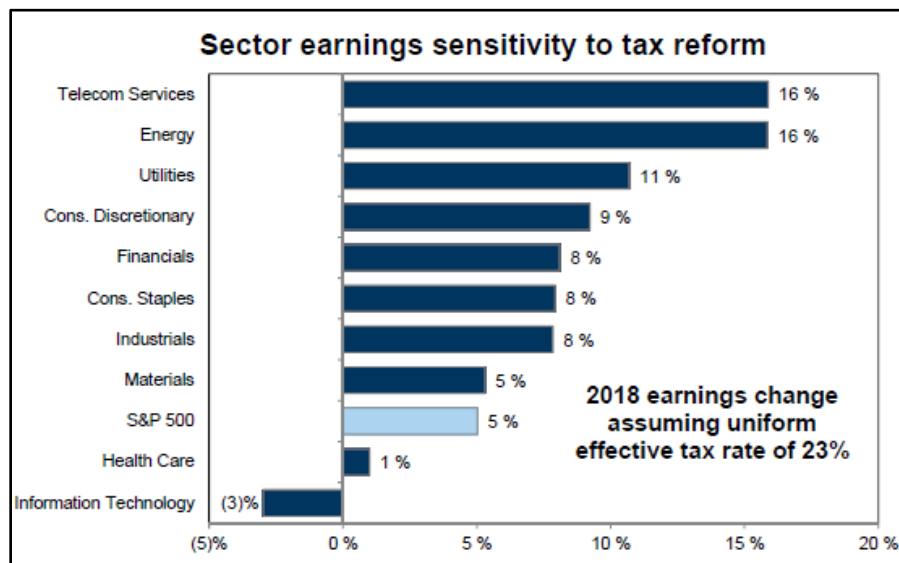
We use a proprietary process to measure risk. We apply this process to both markets and individual stocks. The chart above shows the current composition of total US equity market value. This is comprised of total invested capital (blue) (+) current value added (CVA, red) (+) future value added (FVA, grey). The FVA represents the portion of the market cap that depends on future growth. This is the market's expectation and reflects the degree of investor enthusiasm for stocks. When this grey segment is large, it means that investors have high expectation for future growth. This is intangible and ephemeral and subject to rapid change. At present, the grey portion is 30% of total US equity market cap, meaning that at least 30% of the market's current value could evaporate through a mere change in investor sentiment. This relates directly to our previous discussion of volatility. When volatility is low, investors are willing to pay more for unknown future growth. The best opportunities to buy stocks are at points when the grey section is the smallest relative to total market value.

We monitor these fundamentals carefully, but stock prices lead changes in fundamentals, both company specific and macro. When the economy is entering a recession, price volatility rises, and the subsequent confirmation of worsening economic data sends stocks substantially lower. For value investors, the best returns are gotten when the economic cycle is bottoming and recovering, not when the cycle is topping and entering a recession. We mentioned earlier that EPS growth was slowing, but estimates for 2018 EPS for the S&P are +14% vs. the 10% we saw for 2017. Much of this expected growth for 2018 can be explained by the newly enacted corporate tax reform bill.

Understanding Corporate Tax Reform

On balance, we believe corporate tax reform will increase the after-tax cash flows for the majority of our portfolio holdings. Overall, the tax cut should add approximately 8% to S&P 500 recurring EPS growth.

Sectors and companies will benefit to varying degrees depending upon the geographic mix of sales. The sectors most positively affected are Consumer Staples, Financials, and Industrials; the least benefit will accrue to Information Technology and Health Care. As a general rule, companies that have more US revenue relative to foreign, have suffered from higher tax rates, and stand to benefit most from tax reform. For our portfolio, the companies we expect to benefit most include: CVS Health & Robert Half (tax rate = 39%); Williams-Sonoma & Now Inc. (tax rate = 36%); Valero, Wells Fargo, Markel, and Campbell Soup (tax rate = 32%).



Source: EvercoreISI

Another aspect of the tax plan that will affect US companies concerns the deductibility of interest expense. Corporate tax reform limits the deductibility of interest expense to 30% of EBITDA for four years, then 30% of EBIT thereafter. This stands to make debt more expensive and will impact smaller companies more than large. It may lower stock buyback activity, much of which has been financed by debt. It will also grow more impactful when interest rates rise. There are positives, however; free money has kept poor businesses alive; a higher cost of money will pressure marginal companies out of business. This may be good for our portfolio as most of our companies are looking for cheap assets to buy. Outside of the interest deductibility limits, a lower tax rate increases the after-tax cash flows of US companies. This lowers the required rate of return on capital investment projects. Our hope is that this will make capital projects more tenable and inspire growth-focused investment.

How Will This Situation Resolve Itself?

There are a couple of ways this unusual market will resolve itself. We know valuations will normalize, the question is how it happens. Will be fast or slow? Fast would mean price declines to fit current EPS; slow would imply stagnant prices that linger near current levels while EPS catch up. Bond yields are low and will rise. If market conditions remain stable, the Fed can gradually raise rates and allow valuations to deflate gradually. In this scenario, value opportunities will remain scarce. The other possible outcome is sudden stagflation – a material negative growth shock and/or a burst of inflation. This would cause a more rapid rise in rates and compression of valuations. This would be scary, but would also provide more opportunities to find value. Genuine value opportunities are most plentiful when investors are scared and selling for emotional reasons.

Conclusion: Should Goldilocks Fear the Bears?

Valuations are clearly high, but this is rarely the cause of bear markets. Bear markets are usually brought on by the confluence of slowing growth momentum and tightening monetary policy at a time of extended valuations. There are three basic types of bear markets: cyclical, structural, and event-driven. Each results from a different source, has different severity and duration. We view our greatest risk, presently, to be a cyclical bear. Cyclical bears come around when economic conditions enter recession, hampering profit growth as interest rates rise. Our current caution stems from the knowledge that points of cycle low unemployment and high valuations are usually followed by periods of poor returns.

Because of where we are in this extended economic cycle, which has been long but shallow, companies have focused on cost cutting to drive profits. US companies have been very successful at controlling costs and thus operating margins are at all-time highs. This affects our process because we look for quality companies with temporary problems that can be corrected by a capable management team. Stocks that are attractive to us will have been driven to low valuations by declining fundamentals – weak revenues, weak pricing, weak margins, and weak profits. Often, the corrective measures taken by management revolve around driving margins back to normal levels or higher. One reason values are so hard to find is that, after such an extended period of corporate cost cutting, even companies with reasonable valuations have limited room to improve margins.

So, while we'll miss Goldilocks, we welcome a future investment climate with more plentiful value opportunities. We ordinarily get such opportunities when most other investors grow fearful and sell stocks irrationally. We're preparing for this eventuality by fortifying our portfolios, building our house one brick at a time. Only from a position of strength, with ample cash, and a viable set of ideas, can we benefit from the more accommodating market we expect. We're certain that our time-tested investment process will allow us to generate stable returns through this frustrating stage of the market cycle, and then capture superior returns once values are more plentiful.

PLEASE SEE IMPORTANT DISCLOSURES BELOW:

As of December 31, 2017, Hutchinson Capital Management (HCM) held:

478,029 shares of NOW INC COM (DNOW)
529,371 shares of NATIONAL OIL WELL VARCO (NOV)
752,031 shares of MOSAIC CO NEW COM (MOS)
196,577 shares of JOHNSON CONTROLS INC (JCI)
60 shares of AMAZON.COM INC. (AMZN)
0 shares of AETNA INC. (AET)
448,970 shares of ROBERT HALF INTERNATIONAL INC (RHI)
348,538 shares of WILLIAMS-SONOMA INC (WSM)
158,019 shares of VALERO ENERGY CORP. (VLO)
362,144 shares of WELLS FARGO & CO (WFC)
16,789 shares of MARKEL CORP COM (MKL)
193,257 shares of CAMPBELL SOUP COMPANY (CPB)

As of December 31, 2017

NOW INC COM (DNOW) closed @ 11.03
NATIONAL OIL WELL VARCO (NOV) closed @ 36.02
MOSAIC CO NEW COM (MOS) closed @ 25.66
JOHNSON CONTROLS INC (JCI) closed @ 38.11
AMAZON.COM INC. (AMZN) closed @ 1169.47
AETNA INC. (AET) closed @ 180.39
ROBERT HALF INTERNATIONAL INC (RHI) closed @ 55.54
WILLIAMS-SONOMA INC (WSM) closed @ 51.7
VALERO ENERGY CORP. (VLO) closed @ 91.91
WELLS FARGO & CO (WFC) closed @ 60.67
MARKEL CORP COM (MKL) closed @ 1139.13
CAMPBELL SOUP COMPANY (CPB) closed @ 48.11

As of December 31, 2017, the following were the ten largest holdings of HCM:

Name of Issuer	% of Equity Portfolio	12/31/2017 Closing Price
NOVO-NORDISK A S ADR	6.92%	53.67
ROBERT HALF INTERNATIONAL INC	6.53%	55.54
INTEL CORPORATION	6.35%	46.16
CARNIVAL CORPORATION	5.76%	66.37
WELLS FARGO & CO	5.75%	60.67
JACOBS ENGINEERING GR	5.64%	65.96
MOSAIC CO NEW COM	5.05%	25.66
MARKEL CORP COM	5.01%	1,139.13
NATIONAL OIL WELL VARCO	4.99%	36.02
WILLIAMS-SONOMA INC	4.72%	51.70

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.
