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"It's quiet. Too quiet."
John Wayne, from the movie *The Lucky Texan*, 1934

Dear Friends,

We opened our last letter to you by discussing the most remarkable aspect of the great bull market of 2017 which was the absence of volatility. It was as if someone had taken a protractor, plotted out a 19 degree slope and the stock market simply followed the line. This year, no such luck. First, the return for stocks as measured by the Dow was *minus* 1% for the first half. Secondly, we have not lacked for volatility. The first six weeks of the year saw the Dow run up nearly 2,000 points only to see the average reverse to *down* about 1,300 points by the second week in April. At this writing we are back nearly to where we started the year. One would think with corporate earnings estimated to be up in a range of 15 to 20% that stocks would be running on all cylinders. Congress has passed laws friendly to corporations, employment is booming, house prices are rising, people are spending and it's summer! Yet with the exception of a handful of tech stocks, it has been quiet. Too quiet…

Always Drink Upstream From the Herd

Hard to argue with cowboy wisdom like this. It's simple and easy to understand. Just like investing! It is not uncommon for us to be asked to explain our investment philosophy. We are about to take on this Big Idea but ask that you first allow us to briefly digress.

Back in 1974 the chair of the House Ways and Means Committee was Oregon's Al Ullman. When asked about a piece of legislation concerning capital gains at a meeting which your writer attended, Rep. Ullman responded, "*Just because you don't understand it and I can't explain it does not mean it is a bad idea."* (Clearly Al had been drinking from downstream.) Our point in sharing this story is that there is a natural tendency to overcomplicate Big Ideas such as an investment philosophy. We will make every effort to keep things simple, clean and understandable. Herewith follows our Big Three.

1.) <u>The value of any asset over time is highly correlated to its ability to generate cash</u> (known in the accounting world as free cash flow). The easy way to think about this concept is a duplex. Assume you find a nice little plex which is well located, has a good rental history and is in good condition. The seller is asking $550,000 and the bank requires a 20% down payment of $110,000. Rents are $36,000 per annum but mortgage, taxes, insurance and maintenance run $42,000 a year. Instead of producing cash, our prospective duplex requires the owner come up with $6,000 a year to cover the *negative* cash flow which arises from expenses exceeding income. Negative cash flow does not mean it is a bad building; it's just an overpriced property. If we require the duplex to produce a return of 5% on our down payment, the purchase price for the property would need to be about $400,000. Stocks can be viewed in the same fashion by simply looking at the cash flow "yield" otherwise known as the amount of cash that has accrued from operations over the past year. Note again: free cash flow. As it relates to the stock market today, it is challenging to find companies whose price to cash flow clears these valuation hurdles. Footnote: It's also nice to have talented management working for shareholders who have a history of reinvesting this free cash flow in the business while growing the annual dividend.

2.) Balance sheets matter (aka a net worth statement). Total assets minus total liabilities. Every time you complete a net worth statement for the bank or a mortgage application, you are preparing a balance sheet. From an investor's standpoint, a high grade balance sheet aligns you with a company that has tremendous financial flexibility. Funds are available to invest in plant and equipment. Acquiring another company that can fit into your business model hand-in-glove is a possibility. In a perfect world, such a combination actually produces cost saves for both entities leading to the sum of the pieces exceeding the whole. Repurchase of shares is a common practice these days as funds formerly held overseas are brought back onto companies' balance sheets. Warren Buffett is a big fan of the latter. He recently took Berkshire Hathaway's holdings in Apple from zero to five percent of the entire company in less than eighteen months. Buffett is excited about Apple's ambitious plan for retiring shares. With each retired share, BH increases the percent of the company it owns without investing another nickel. Such are the benefits of a strong balance sheet (and did we say fed by free cash flow?).

3.) Embrace Controversy. Of the three primary disciplines we follow, this one is the toughest. Sticking with our Apple metaphor, the company was one of the stock market's darlings rising over seven-fold from a split adjusted $13.50 in early 2009 to $102 in the summer of 2012. Apple hit a series of speed bumps and fell from favor thereafter falling to $69 in early 2013 eventually bottoming out at $56 (split adjusted) in April of 2013. The analysts and the media were down on the company due to a series of product disappointments and growing competition. From our perspective, Apple generated immense amounts of cash that was piling up on its balance sheet, was pursuing new technologies, had little debt and was soberly priced in relation to the then depressed earnings. We first purchased stock in smaller amounts around $69 and continued to buy the stock over the next few months as the shares fell in price. These serial purchases served to simultaneously increase our holdings in what we perceived to be a bargain while at the same time lowering our average purchase price. Today the stock at going on $200 is our largest holding. By our valuation standards, despite the stock growing three-fold from 2013, Apple is just a bit rich in valuation in relation to its free cash flow and fortress balance sheet. Were we more prescient than the technology experts? No. Was the stock highly recommended by the various research inputs we have access to? No. Was there risk that the company would fail to execute on their opportunities? Yes. Was there a possibility Apple would exceed the low expectations the market had for the company? Yes. The takeaway? Low expectations coupled with strong balance sheets and a tsunami of cash flow tilt the playing field in our favor. Not to mention giving the management time to address the issues. Just the way we like it!

If You Are Riding Ahead of the Herd, Look Back Every Now and Then to Make Sure it's Still There

Where do we stand today in relation to the herd? We are either considerably out in front or eating dust and lagging behind. Only time will tell which. But we are not uncomfortable riding out in front. In our view, four long shadows hang over the market.

- Valuations to cash flow and earnings are sky high by historic standards.
- Quality of earnings is poor, driven largely by gains from cuts in the taxes corporations pay as opposed to selling more product at better prices.
- TINA (There Is No Alternative to stocks) is headed out of town on the next stage coach as interest rates rise and bonds begin to provide a less risky and viable alternative to stocks.
- Trade wars: the functional equivalent of a circular firing squad.

At present, for most accounts, we are under-invested in stocks with a good deal of money being rolled over in short term CDs and investment grade bonds. Please allow us to be clear, this is not an effort to call market tops. If we are true to our discipline, there will be times when the pickin' is thin and patience required. On both our part and yours. The malaprop we like to abuse is, *Don't do something…just stand there*. You can count on our reversing this position in market downdrafts when prices decline and value driven opportunities go up. Think about the serial purchases Buffett made in late 2008 and early 2009 when the world as we knew it was ending and he was making a new multi-billion dollar investment virtually every month. Clearly he had distanced himself from the herd and was comfortable being there.

Not Our First Rodeo

Only partner Marcia Hull is a regular attendee at the Pendleton Round-Up. As she is on vacation this week and not available to wrap up our Letter, we are going to advance the idea that Brahma bull riding is the heavy-weight event of the rodeo. One cowboy gets the cash and trophy and the others have nothing but bruises and broken bones to show for their ride. You may recall that in our last letter partner Chris Klavins penned a nifty piece on the hot topic: Bitcoin. Chris's article could have been subtitled *Not Now, Not Ever* panning Bitcoin then trading at $17,200. As of this date, Bitcoin trades at $6,302, a decline of nearly two-thirds. Steve Spence, on the other hand, praised the recovery potential of GE in the $16-$17 range; now $14. So… the trophy goes to Chris and the bruises to Steve.

One other shout out needs to go to Will Rogers who is responsible for the headers to each of our paragraphs. Sure would have been nice for us to have not lost old Will in a 1935 Alaska plane crash. Just think about how much more wisdom and humor he might have imparted and how much easier it would be for us to write these letters!

As is our custom, we close our July letter with an appropriate suggestion as to where to spend your summer vacation. Given the minus 1% return the stock market has produced thus far this year and the sky-rocketing cost of gas, it is a safe bet that we are not going to travel very far. We suggest none other than the Pendleton Round-Up. We understand the Rainbow Café is the place to go for cold beer and some fine eats.

Let 'er buck!

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