January 2019

Dear Investor,

2018 saw a return of volatility to global stock markets. After dizzying falls and not quite as dizzying rises, markets ended the year down. The S&P fell by 4.6%, the Russell Microcap index, which tracks smaller companies, fell 14% and most international stock indexes fell by more than ten percent. The Barclay's bond index was flat for the year, but high yield bonds and preferred stocks were both down by roughly three percent for the year.

Shares in businesses that rely on a strong economy, such as banks and manufacturers, performed especially poorly. That weakness came despite many of these businesses reporting strong earnings throughout the year. Investors are concerned that slowing overseas economic growth and rising US interest rates are likely to lead to a recession in the United States, or at least to a pronounced economic slowdown. In the final weeks of December those concerns were exacerbated by weak economic data from China and statements from the Federal Reserve that it expected two interest rate hikes in 2019.

US economic data has been mixed of late. Single family housing construction, an important part of the US economy, peaked in the summer, and has since fallen modestly. In addition, recent corporate earnings reports suggest that consumer spending growth has slowed. On the other hand unemployment, which is ordinarily high prior to a recession, is at historic lows. In addition, China and the US are presently engaged in trade negotiations. Any easing of trade tensions would be supportive of economic growth for both China and the US.

The broad sell-off in markets has depressed some stock prices to levels at which they are attractive relative to the earnings of their businesses. In addition, price declines for some of our preferred stocks and bonds have boosted their yields by one to two percent.

<u>Notes on specific holdings</u>

Shares of Constellium had a particularly bad year despite the company reporting strong earnings. Constellium manufactures highly processed aluminum used to build planes and automobiles as well as beverage cans. In recent years the company's earnings have grown steadily; for a time the holding was among our best performing stocks. Of late the stock price has fallen substantially, largely on concerns that weaker automobile sales will reduce demand for Constellium's products.

While that's possible, I don't think the market is giving Constellium enough credit for its sales to aerospace and aluminum can manufacturers. These together account for 75% of the company's sales and should continue to do well. We can be fairly confident of that anticipation because the materials used in aircraft construction are ordered far in advance of an aircraft's actual assembly, while the consumption of aluminum for food and beverage cans is unlikely to be much impacted by an economic slowdown. And while the company's sales to car manufacturers might be bumpy from year to year, they should grow over time. That's because many new car models substitute aluminum for steel in an effort to reduce vehicle weight and thereby improve fuel efficiency.

CVS Corp's stock also fell last year, hurt by concerns that Amazon will move into the drug retailing business. While that's a reasonable worry, it will probably take a number of years to establish a convenient online platform for pharmaceuticals. Drugs require unique warehousing: some require refrigeration; others, notably narcotics, require secure storage and tracking. In addition, each drug purchase must be reviewed by a human pharmacist and paid for by an insurance company, making it harder to automate the purchase process.

Those issues will likely slow competition from Amazon. In the meantime, CVS is adding home delivery to its service offering, so that it will be better positioned to compete in the future.

CVS's business is also more diverse following its acquisition of the health insurer Aetna. Insurance and insurance related businesses now represent more than half of the company's earnings. These businesses have been among the best performing in health care, and should continue to grow.

I have used the recent volatility in markets to add incrementally to our holding of Amazon. This had previously constituted a relatively small position. Amazon continues to report rapid sales growth in its cloud services division where customers can outsource their information technology needs. At the same time, Amazon's transition from a primary seller of goods to a platform for other merchants is resulting in profitability gains. While Amazon's stock is not cheap relative to its earnings, recent selling brought that ratio down to more reasonable levels.

<u>Notes on income holdings</u>

I continue to look for high quality bonds and creditworthy preferred stocks that together are likely to reduce the volatility of your portfolio.

For 2018, returns on our income investments were modestly negative, partly because the prices of bonds and preferred stocks were high at the start of the year. They have since fallen to price levels where I think further declines are less likely and to the extent they did occur, would be largely offset by annual interest and dividend payments.

During the market sell-off in December, these holdings, which provide predictable interest and dividend payments, performed better than stocks. That is likely to continue should the economy slow.

As always, please contact me with any questions.

Doug