April 2019

Dear Investor,

Investor optimism has been buoyed by statements from the Federal Reserve that it is unlikely to raise rates again this year as well as by the hope that we're near a trade deal with China. That optimism has been sufficient to outweigh continuing concerns about corporate earnings growth and international economic growth. Indeed, stock prices are back to levels that imply optimism about the next few years. That's quite a change from December, when investors' fears of recession led to plummeting stock valuations.

Signals from the bond market are less clear. Long-term interest rates have fallen to the level of short-term rates, an indication that bond buyers anticipate slow economic growth. In the past the convergence of long-term and short-term rates has often preceded a recession, although the lead times have varied, and recent data continues to point to a stable US economy.

Given the difficulty of predicting recessions, my preference has been to invest in businesses that can maintain their profitability even in a weaker economy. A few of our holdings, notably our investments in banks, are more dependent on a strong economy. We made those investments when bank stocks were significantly out-of-favor, and therefore prices were very attractive, even as bank earnings were improving from depressed levels. While bank share prices are still somewhat attractive relative to their assets and earnings, those earnings are vulnerable to any weakening in consumer or commercial credit. This is just the development we would expect if the economy weakens. With this in mind I have gradually been reducing our exposure to banks, and expect to continue to do so.

<u>Notes on specific holdings</u>

Our recent performance has been helped by strong gains in the shares of Infusystems, a provider of ambulatory infusion pumps. I sold most of our holding of this stock in 2017 following an adverse regulatory development. Shortly thereafter the company's board installed new senior management with a more compelling business strategy. As it became evident that the new team was achieving good results, I began to repurchase Infusystems shares. So far the decision to reinvest in the company has proven correct.

While most of our holdings are up for the year, shares of CVS continue to disappoint. Last quarter I wrote that CVS's share price reflected worries about competition from Amazon that was unlikely to materialize for at least several years. However it's now clear I underestimated other near-term pressures facing CVS's retail business. These include price pressures from generic drug producers, as well as from drug price middlemen, who negotiate reimbursement rates on behalf of insurance companies. In addition, CVS's sales to nursing homes, an important customer segment, have fallen as nursing homes confront financial difficulties of their own.

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CVS stores represents a little less than half of the corporation's overall profits, with the balance now comprised of the health insurer Aetna and one of the largest drug price negotiators, Caremark. Over time weakness in CVS's retail business should be offset by growth in Aetna's insurance business. Nevertheless, it now appears that CVS's earnings growth will be slower than I had expected.

The issue of the possible adoption of a single payer national health plan has been much in the news and has implications for our investments in both CVS and the health insurer Anthem. Such a plan would move the payment for health care from the private sector to the government. The costs of such a move would presumably be financed through higher taxes. Early polling suggests a majority of voters support single payer insurance until they are told it would likely mean higher taxes, at which point their support drops substantially.

Single payer will also face tough opposition from the health industry. In parts of the health system, including hospitals, dialysis centers, medical labs and doctors' offices, commercial reimbursement rates are higher than those paid by the government. Should reimbursement rates drop, it seems likely that the millions of Americans employed by the health industry would earn less and in some cases lose their jobs. Investors in the industry would also incur substantial losses. These large constituencies will be important voices in any debate.

Finally, it's hard to see a legislative path for a transformative health care bill. Single payer legislation would be opposed by Republicans on ideological grounds and by some Democrats from states that depend on the private health sector for jobs. That means that even if there were a Democratic majority in the Senate, Democrats would probably fall short of the sixty votes needed to override a filibuster.

As always, please contact me with any questions.

Doug

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