LOUDON
INVESTMENT MANAGEMENT

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Dear Friends:

We want to thank you for your interest in our company.

At the outset we should note that our approach is not for everyone, and we accept this as a limitation on our future growth prospects. While we are flexible in a number of ways, were we to alter our style to meet everyone's desires, it is unlikely that we would have been able to produce the investment performance results you will find enclosed. We are income and value oriented investors. Those looking for investment excitement would probably do better to look elsewhere.

While we believe we can identify value, the timing of the recognition of value by others is uncertain and always subject to the whims of the marketplace. We don't seek excitement but we do look for investments likely to produce reliable and positive long-term returns. We consider patience and conviction the keys to this process. We are realists and investors, not dreamers or speculators.

Within our stated approach, we construct unique investment portfolios suitable to the needs of each of our investors. We invest for the long-term. This keeps commissions and taxable gains at a minimum, and allows us to ignore most of the short-term noise produced by Wall Street. Historically, the average holding period for our investments has been about five years. Our focus on higher income yielding stocks means that we are often at our best when others are losing ground. Our long-term objective is to provide a return to our clients, net of our fees, superior to an appropriate market benchmark, but with lower volatility than the benchmark itself. While there are no guarantees in this business, we do our best to see that we all can sleep well at night. For those with a quantitative bent, statistics indicate we have historically been high "alpha" managers. Since we opened for business in January 2003 our returns to investors have averaged over 9% per year after a deduction for our fees.

Communications and a high level of client service are integral to our approach. If you don't know what is happening to your investments, how can you judge the job we are doing and how can we expect you to have the patience required for an investment to mature and performance to materialize? We normally provide quarterly and annual performance reports, including our outlook for the markets and the economy as well as your assets. Interim updates are provided as appropriate and we are always available to answer questions. We never forget that it is <u>your</u> money we are investing.

<u>Our Portfolios - Equities</u>

The equity portion of our portfolios do not look like the overall equity "market" and are often not constructed like typical balanced portfolios either. This is our performance advantage.

We try to concentrate our holdings in the "better valued" and "higher quality" sectors of the investment markets. Better valued means that the securities we buy are both historically and prospectively selling for less than they are worth. High quality reduces fundamental uncertainty and therefore allows us to invest with greater confidence for the long run. The normal annual volatility of even a very high quality investment means that if purchased at low ebb, the returns on the investment of your money can well outrun the underlying fundamental progress of the general economy and the company itself.

If you take the perspective of a full market cycle, the short-term orientation of many individuals and advisors continually produces valuations well off the "fair value" mark. This is particularly true today. And as a stock price moves lower, the income flow produced by the dividends per dollar we invest increases. At the present time our typical portfolio provides a return from income alone of over 3.5%. We won't commit to any equity investment unless the income yield is above the market (today about 2%) and also above its own historic range. And, at least for the time being, individual investors should remember that qualified dividends, unlike interest income, are still taxed at a somewhat reduced rate.

If the price of an individual stock moves up at a rate well ahead of its fundamental progress as measured by cash flow, dividend and earnings growth, we are perfectly willing to realize the gain and pay the taxes due. We then try to repeat the process by buying another high quality depressed issue producing current income above both the general stock market and also what we have sold, net of taxes. Over time this approach ratchets up the growth in current income production and the investment performance versus what it would have been were we just buy and hold investors. We are completely open minded about what we will own although purchases are generally limited to what we believe are "investment grade" securities.

Differences between what a stock should be worth in the long run and what it is selling at occur continuously, usually because of short term news. A good example is our holding of Cardinal Health. In our 2013 mid-year letter to clients we reported the following:

> In April (2013) we purchased a new stake in Cardinal Health, Inc. (CAH). Cardinal Health is one of the nation's largest pharmaceutical and medical distribution companies, but it has been forced to make some difficult decisions recently. Over the last year Cardinal lost major contracts with Express Scripts and Walgreens. Each represented about 20% of Cardinal's total revenues, but both were largely "bulk" contracts with extremely low profit margins. More recently the company announced that it will renew its earlier lost contract with CVS, now its largest customer.
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> All in all we applaud the management's decision to shed contracts that were minimally profitable at best. While the loss of business from Walgreens won't take effect until the end of August, Cardinal has absorbed the loss of its Express Scripts business well, showing a significant uptick in profit margin since the change. While there may be some short-term expenses and loss of economies of scale from exiting this business, the move should ultimately free up working capital that can be reinvested in the more profitable remaining business or new acquisitions, or returned to shareholders via increased dividends.
>
> Cardinal carries an income yield that is comfortably higher than the market (and many bond alternatives), around 2.6% at the time of purchase. Over the last ten years the company has raised its annual payout by over 25% on average. While we don't anticipate dividend growth nearly this high over the next ten years (the most recent increase was a 10% boost announced in April after our purchase), it is a clear sign that

> management is focused on returning money to shareholders. Meanwhile Cardinal's prospects for future growth are strong; it has a low and manageable debt load, plenty of room to continue raising the dividend, and trades at a significant discount to its peers and the market at around 13X current earnings. If the company simply continues doing what it does well, we believe there is plenty of upside in the stock over the next several years.

This was a classic example of negative short term news (loss of low profit accounts) overriding what looked to us to be a highly promising future. Purchased in the low forties, the stock now sells around $76 per share, rising as the focus on the bad news faded. We have already cut back the position in many accounts (at higher prices) as it ran right though our estimate of "fair value" to the point that some action was justified. Note that throughout this period, there was very little change in expectations for the company's long-term health. The only thing that changed was perception and the market value.

So what to do with the funds generated from the sale of companies like Cardinal Health? Fortunately we always have a few undervalued stocks in the wings. Our most recent purchase was Enterprise Products, a high quality pipeline company with a 7% income yield. Although Enterprise earns most of its money based on fixed fees from the petroleum product pumped through its pipelines, it has declined as though it is directly related to the price of oil. This misperception has allowed us to purchase shares of the company at a price not seen in five years and with a high dividend yield backed by lots of cash flow as well as ten years of quarterly increases in the dividend.

These kinds of discrepancies in valuation (both high and low) occur in the stock market with great regularity, generally based on short-term or market cycle factors. As long-term investors, we spend a large proportion of each day looking for changes that will increase income and value without sacrificing quality.

<u>Our Portfolios - Bonds</u>

We own very few long-term bonds unless there is a client based need or requirement for them. There are two reasons we don't like bonds, one philosophical and one practical. The philosophical reason is that bonds have historically underperformed stocks over a full market cycle, although they have contributed to stability of total asset value. If you looked at all the five year time frames since the end of World War II, you would find that the number of instances bonds outperformed stocks was very limited – less than 10% of the time. We see no reason that stocks shouldn't continue to do better than bonds (particularly from today's low interest rate, high bond valuations) assuming a willingness to tolerate short-term variability in price and accept a long-term (3-5 year) point of view. Asset class diversification is not an end in itself but a way to reduce volatility and may result in lower long term returns.

The traditional reason for owning bonds has been to produce current income and provide portfolio stability. However, the equity income yields on our portfolios are already substantial and today are also higher than the typical balanced portfolio as well as even twenty year U.S. Treasury securities. We believe that the attractiveness of bonds should be judged through the same prism that is applied to stocks. At such time as bonds appear more attractive we will be buying - but for the time being they just don't make the cut, even if we assume that the money that has been pumped into the economy over the past several years doesn't bring higher inflation. If inflation arrives, which we believe it inevitably will at some point, bonds will reverse their gains of the past and could end up with negative returns for some extended period. In general, we prefer to hold a combination of money funds or short-term fixed income securities along with stocks rather than make a large, long-term bet on the bond market.

The importance of sticking to the disciplines suggested by the above cannot be overemphasized. While our approach to risk control and interim volatility is different than that of many other advisors, it is something that is high on our list of priorities. Our experience has been that if the large losses can be avoided, aggregate performance will often take care of itself. While our performance will likely lag as the market moves into overdrive on the way up, we hope to hold on to a good portion of our gain when the financial markets move lower.

We hope you will give us a call if either this letter or the exhibits that follow give rise to any questions.

Very truly yours,

Loudon Investment Management, LLC