Loudon Investment Management, LLC
24 Airport Road
West Lebanon, New Hampshire 03784
Phone: 603-298-7370
FAX: 603-298-7375
Email: LIM@loudoninv.com

Douglas M. Loudon, CFA Emily L. Sands, CFA John J. Sands, CPA Lynn O'Mealia

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Dear Clients and Friends:

Did Brexit really happen?

On Thursday June 23 the Dow Jones Industrials closed above 18,000, near its all-time high. However, over the next two days after the vote by the British public to exit the European Union, the Dow reached a low just above 17,000. Then direction was reversed and on July 1, it reached a high again above 18,000 before settling back later that day. While "Brexit" was being described as a crisis, the stock market acquitted itself well as it went through the sorting out process of the various investing alternatives: but in the end, at least temporarily, the stock market acted as though nothing had happened.

The bond market was a different story as a panicked flight to stability and quality seemed to override common sense and yields on high quality bonds declined as money flooded in. You can now earn all of 1.3% annually (pretax) for the security of holding a ten year U.S. Treasury Bond. At the same time, the income yields from our stock portfolios average about 3.5% with the promise of additional growth in both income and capital value.

There were some more serious consequences in both Britain and Europe. Both the Euro and the British Pound declined with the latter down about 20% versus the U.S. Dollar and seemingly still in decline. On the good news front, this means that it is cheaper than it has been in a long time if you want to vacation in Europe. It also means that it is cheaper for British manufacturers to sell goods to us. On the bad news side, with the pound worth less, anyone who owns British stocks or real estate has taken a pounding. In fact, several British real estate funds have already moved to block redemptions to prevent forced selling and even lower valuations.

So without getting into all the trade and economic implications of the British exit from the Eurozone, the markets, as usual, are in the midst of sorting it all out through the mechanism of price. There will be eventual winners and losers in this process but it will take some time to figure out what is what in spite of all the interim movements. But with at least two years before the formal exit, currently it is not at all obvious who they are.

There may also be some benefit to what has happened. Europe has been in an economic funk ever since the 2008-2009 financial crisis. In this sense change, however uncomfortable in the near term, may be good in that it will force all the players to rethink what is not working and hopefully make changes to benefit the future. But given the nature of the entrenched bureaucracy of the EU in Brussels, at the moment all we can do is hope.

Performance

	6 Months Ending 6/30/2016
Benchmark Indexes	
Lipper Balanced Fund Index	3.5%
S&P 500 Stock Index	3.9%
Russell 1000 Value Index	6.5%
Money Fund Average	0.1%
S&P 7-10-year-US Treas. Bond Index	7.2%
S&P Thirty Year US Treas. Bond Index	18.8%

Above are the performance results that reflect everything that has happened since the beginning of the year. The clear winner has been the bond market and the longer the bond maturity the better. So while long-term U.S. Treasury Bonds may currently yield only about 2.5%, the unprecedented further decline in rates since the beginning of the year has meant high short-term gains in price. It is difficult to see how rates can decline much further but we would have said the same thing two years ago so we have little confidence in saying more declines are not possible. Longer-term, we continue to worry about the consequences of eventual higher rates on the value of all financial assets, but again, this is not a new worry.

Updating our Top 20 Stocks

This quarter we saw some turnover in our top 20 holdings. Our additions to the group include new holdings Ameriprise Financial and Viacom as well as Pebblebrook Hotel Trust which we have bought and sold in the past.

Pebblebrook was originally purchased in 2011 as a brand new hotel REIT (real estate investment trust) that was created in order to purchase distressed, high end hotel properties out of the rubble of the real estate crash. It was a great investment for us, and we sold most of our holdings well over a year ago. Due to some recent issues which we believe to be temporary, Pebblebrook stock once again caught our eye recently when the price was cut in half from its February 2015 peak, and we also noted that the near 6% yield was higher than it had ever been due to some generous dividend increases over the last several years. We see no reason why Pebblebrook should not return to its previous high at some point over the next five years and it pays us well to wait for that to happen.

Like most financials, Ameriprise stock was in a general decline from the middle of 2015 through February of this year, and over that period the price was cut in half. While we are not a great fan of the financial stocks as a group, we do believe Ameriprise's business model, with its focus on asset management and insurance, is likely to provide a fair amount of stability compared with many of the big banks that are again taking on more risk in their own portfolios. While we didn't pick it up right at the low, we do believe we bought a solid stock with plenty of upside potential and a 3% yield while we wait. We view Ameriprise as a solid holding for the long term.

Viacom, a cable content provider which owns some solid brands including Nickelodeon, MTV, VH1 and Comedy Central as well as Paramount Films, recently dropped to rock bottom prices. At one point the company had lost two-thirds of its value. Like many media companies, Viacom is struggling a bit as more households cut the cable cord in favor of internet and satellite TV. Viacom has, however, been taking the steps necessary to adjust to a mobile world. Ongoing concerns regarding the ailing controlling shareholder, 93 year old Sumner Redstone, may add to uncertainty in the near future. Most recently Redstone (or those around him) made a move to replace five of the company's eleven Board members, including its long-term CEO. While the turmoil is likely to continue for some time and those who were fired have threatened to sue, we believe the drop in stock price has been overdone, and the company holds many valuable assets. Viacom currently has a 4% yield that is very well covered by cash flow, and it is trading at an extremely low eight times this year's expected earnings and only ten times cash flow. All in all we do expect a bit more volatility in Viacom versus other purchases, but with extremely low expectations priced into Viacom it wouldn't take much at all to move the needle.

Dropping out of our top twenty holdings were PepsiCo, Digital Realty, and ConocoPhillips. Pepsi, like many stable consumer stocks has strongly outperformed the market over the last few years. While the dividend has largely kept pace with price, the stock now trades at twenty times expected earnings with an anticipated growth rate of 6-7%. This is pretty rich by our standards. A market premium for Pepsi may be warranted due to its strong financial position and stable cash flows combined with its strong brand names. But at current prices we took the opportunity to lock in some of our gains in the stock, in most cases trimming back the position rather than selling it outright.

Digital Realty Trust is a similar story although it has been a bigger winner than Pepsi. This holder of technology-related real estate has nearly doubled in price over the last two years. Meanwhile dividend increases have not kept pace with the stock price and the current yield of 3.5% is quite low for a REIT. We have actively been trimming it back.

Lastly, ConocoPhillips performance has been lackluster year to date, but with lots of volatility. Conoco did take the unfortunate step of cutting the dividend in early February. We have generally found it best not to have a kneejerk reaction to bad news, as the announcement of a dividend cut often corresponds with a low price for a stock. Within a month Conoco stock had bounced back quite a bit, helped along by a significant improvement in oil and gas prices. At that point we took the opportunity to trim or sell much of our Conoco holdings in order to purchase the stocks listed above as well as adding to our existing position in pipeline company Enterprise Products Partners. We mentioned this holding in our year end letter. Its purchase resulted in an improved income yield and it has performed well since being bought.

Our trades this quarter were not exactly the same across all client accounts due to existing differences in client holdings and tax consequences (it's always easier to capitalized gains in tax-deferred accounts). However all of these transactions are consistent with our long standing practice of selling stocks whose yields have declined (mostly due to higher stock prices) while buying equal or better opportunity from new, lower risk holdings that have declined in price.

Volatility Continues

Short term volatility seems to now have become a normal part of the financial market environment. As you all should know by now, our preferred method of operation is to find an underpriced, high quality security that also happens to have an above average income yield and buy near the cyclical low. We have a number of quantitative tools that help us compare all the stocks in our universe against one another in terms of historic and prospective value. On the theory that every stock will have its good and bad times in terms of market perception of value, we like to buy at low ebb in the market cycle and sell when enthusiasm overtakes a reasonable estimate of valuation.

However, over the past five years or so, interim volatility has made this process far more difficult as individual stocks rotate between over and under valuation in far shorter time frames. As the majority of the assets under our supervision are taxable, taxes (short term gains in particular) often get in the way of acting to maximize returns in personal accounts. This is a subject we have pondered for some time.

Our solution going forward is that you will probably find us making smaller but more frequent trades over the course of time. This mitigates large tax costs in any one year but will allow us to take advantage of shorter term price movements. As part of this process, we will probably also be broadening the number of stocks held in portfolios to account for our lessor confidence in the price of any one stock at a given point in time. In the investment business this more active approach goes under the heading of "rebalancing" portfolios. There may be the appearance of greater activity, but in the end we don't expect annual turnover to increase. There will just be a greater number of smaller transactions.

For instance, through June 30, Digital Realty (mentioned above) returned over 45%, well in excess of any fundamental improvement in the company. At the same time, another top twenty holding, Teva Pharmaceuticals produced a negative return of about 22%. Teva is about to become the largest company in the world developing and manufacturing generic (low cost-off patent) drugs. There will be some costs as they integrate the generic business of Allergan that they are buying with their own business but nothing near what is implied by the decline in the price. As we continue to like both companies longer-term, the logical thing to do is sell some of the winner (which now looks significantly overpriced) and buy the loser (which remains in our view undervalued and more so once the acquisition is complete). But in many cases in our portfolios, large tax liabilities get in the way of good ideas. In the past our response has been to do what we can while balancing gains and losses, taking into account the unique circumstances of each portfolio. Going forward we plan to take more, but smaller, incremental steps rather than eventually create one large transaction. In this way we hope to more frequently capture gains and avoid the very large tax liabilities that frequently come into play with major changes. As we often do, we have tested this approach on our own accounts before implementing any changes in client portfolios. Over the past eighteen months this would have definitely added performance value. We are now moving to slowly apply this approach in client accounts.

Next?

So given everything that has happened recently what does the future look like? We are only at the beginning of the Brexit impact, not the end. We do not believe that it will result in the disintegration of the EU as has been suggested by some. This would be to the detriment of all in terms of the economic implications. And Britain is an unusual case as they always maintained their own currency rather than converting to the Euro when they entered the EU. Our guess is that much less will change than many are projecting. In fact we are hopeful that the exit of Britain will get the rest of the EU to deal with a number of issues that have been holding back economic progress for years. There is no bureaucracy like a European bureaucracy and, as in the U.S., growing regulation has been a drag on growth.

Although we haven't talked about them, the upcoming elections will undoubtedly provide periods of great excitement (in both directions) for the financial markets. We offer no opinion other than we are not satisfied with either of the main party's choices. We do wish that we could find a President who would concentrate more on domestic issues, particularly economic, of which there are many, rather than foreign policy but we have little confidence that will happen. Nonetheless, America has been great at "muddling through" when the world seems to be in chaos so this should not imply that we are negative on the economy or the markets going forward.

Interest rates are likely to remain low and as long as they do, the stock market returns should be satisfactory though they are not likely to show any exuberance. Our greatest concern is about what will happen when interest rates begin to rise. But this has been a concern of ours (and others) for five years so there is no reason to think an increase in rates is imminent.

As always, please call or write if you have any questions or comment on any of the contents of this letter.

Sincerely,

Loudon Investment Management, LLC

DML/ELS/JJS/LO