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October 5, 2016

Over the first three weeks of July, the stock market had a promising move up of close to 4%, but that was it for the quarter as the S&P 500 ended at 2168, slightly lower than the level reached on July 22. Consistent with the past several years, there were ups and downs after that along with the 5-10% daily moves in an unsettling number of individual stocks that now seems to be the norm. Over the past quarter, looking at our twenty largest positions, the winner was Tupperware, up 14% for the quarter while the loser was Viacom with a -14% decline. The performance of these two holdings does not change our opinion of either.

The index returns for the year to date are as follows:

	9 Months Ending 9/30/2016
Benchmark Indexes	
Lipper Balanced Fund Index	6.5%
S&P 500 Stock Index	7.8%
Russell 1000 Value Index	10.0%
Money Fund Average	0.1%
S&P-BGCantor-7-10-year-US Treas. Bond Index	7.1%
S&P-BGCantor Twenty Year+ US Treas. Bond Index	16.0%

We gave up some ground over the past three months which puts us modestly behind the year to date index numbers. But encouragingly, based on short-term observations, we seem to be back to our long term norm of lagging on the way up but outperforming when the market moves lower. Your own asset appraisal and performance are attached.

The Economy

There is not much new to report here as we continue to tick along at a relatively modest rate of growth although a number of forecasters have moved their estimates for the third quarter somewhat higher.

Looking ahead, the lagging economic indicators are now hitting new all-time highs. This generally occurs during the advanced stages of an economic recovery and suggests that growth is now strong enough to withstand an increase in interest rates. Of course the expected increase in December is the most telegraphed in history and it should be fully baked into the current level of the stock market. But in the world of super short-term investment horizons and sensitivities, we would still expect it to have some impact on stock prices. The real question is what happens after that.

Oil Review

Oil remains a hugely important factor in our economy. As the worst of the downward price movements in oil and gas seem to be now behind us, it is appropriate, and important, to take another look at the current situation to see what impact it may have on future economic growth.

To review the recent history of the price of crude oil, the price peaked at about $140/barrel in 2007, crashed to the mid-forties in 2009, recovered to about $120 in 2010-2011 and then again crashed to under $40 (very briefly below $30) in 2015. It has since been going through a recovery period with oil today priced at a little under $50/barrel. Not surprisingly, the energy stocks have followed suit and life for any but the most financially strong has been pretty miserable.

Recently there have been discussions within OPEC of trying to stabilize production to soak up the excess supply that has accounted for their inability to get prices up. It appears that enough of the countries involved (Saudi Arabia in particular) have now felt sufficient pain to want to concentrate on higher prices, not volume. The removal of most production restraints several years ago appears to have been a replay of action back in the nineties to maintain control of the market by putting high cost producers out of business. That worked but it was more than offset by higher production in other areas of the world.

The low prices have had a devastating impact on domestic shale oil drillers as, on average, they are now operating at about breakeven, and only a few have gotten costs low enough to make a profit. Weaker players have gone bankrupt and many of the better properties have now been consolidated within stronger companies. However, continued improvements to drilling technology have also meant that the cost of production has declined. Several years ago, the breakeven level for shale oil production was believed to be about $60/barrel while today it is closer to $50.

The question, of course, is whether or not oil prices will start working their way higher dragging the oil stocks upward as well? If so, a major profit opportunity could be in the making. One fly in the ointment is Russia which is now pumping crude oil and gas at what are record levels for them.   Russia is not a part of OPEC and it remains to be seen whether they will support any move of other producers to limit supply. The odds are against that happening. Like most of the countries in the less developed parts of the world, Russia and many OPEC countries are not just looking to maximize profits. Rather, they have an ongoing need for foreign currency reserves to pay for their imports. Oil exports go a long way to providing the hard currency needed. Unlike the U.S. shale operators who just shut down if they can't make a profit, these government owned entities just keep pumping, losses or not.

Per the above, North American shale oil operations have now been substantively cut back in response to lower prices. But this means that those reserves are still in the ground. This is in contrast to past experience when low prices led high cost conventional wells to be completely shut down, never to reopen. Increases in U.S. supply are now just a drilled well away from being available to the open market.

This is in contrast to the situation just ten years ago. The shale oil revolution has meant that, if it wanted to, North America could now be independent of the need for middle eastern imports. It is just a matter of price, not supply, as our shale reserves are vast.

Of course, the implication of the U.S. being able to be largely oil independent is huge relative to our geo political interests in the Middle East as well as the U.S. economy.

So what about the oil stocks? Surprisingly, given what has happened to oil company profitability over the past ten years, the stocks have held up reasonably well. That does not mean that owning the S&P 500 Index would not have been considerably better but in spite of the price of oil now at less than half its mid-2000s peak, the stocks are selling at about the same price as they were then. For instance, Exxon peaked at about $72/share in October of 2007. Today it is selling at about $87 after bottoming at about $40 in 2010. Not bad for a company in an industry that saw many of its competitors go bankrupt as the oil price was cut to a third of its previous peak.

The purpose of the above is to remind ourselves that the oil supply picture and that for oil prices remains quite murky. Old relationships between oil and gas prices and our economic and political interests may no longer be valid. If lower prices acted as a stimulant to the economy on the way down, higher prices could very well have the reverse effect. In a still slow growth economy, the price of oil could make the difference between continued growth or recession. And there is nothing the politicians can do about it.

<u>Top 20 Holdings – Update</u>

This quarter continued to see some active changes to our top 20 holdings. Specifically, HCP a major health care REIT and Kohl's Department Stores dropped out of the top 20 largely to make room for new positions in Omega Healthcare REIT and H&R Block.

On its original purchase in 2014, HCP was the only Real Estate Investment Trust included in the list of "Dividend Aristocrats", a distinction it still holds today. Dividend Aristocrats are selected S&P 500 constituents that have increased their dividend payouts consecutively for at least 25 years. During the trials and tribulations of 2008-2009 while most REITs were slashing their dividends, HCP bucked the trend and continued increasing its payouts each year.

However, times are changing for HCP. As we have known for some time, the company put a lot of eggs in one basket and was highly dependent on the fiscal health a single tenant, HCR ManorCare, for a large percentage of its revenues. Several years ago, HCR ManorCare ran into some problems which have resulted in a renegotiation of its lease terms with HCP. As far as we are concerned, HCP is taking the right steps to clean up the mess, as it announced in June that it will spin off the assets of HCR ManorCare into a new entity. In the short term as these changes are executed, we see an increased risk in the stock as the majority of shareholders would prefer to unload shares in the spin-off while continuing to hold the assets in what remains of HCP. There are also questions of what might happen to the combined dividend of the two companies and whether the HCP dividend is sustainable as a standalone entity. HCP would lose its dividend aristocrat status if the combined dividend of the two companies is lower than the rate it is currently paying. We believe HCP remains a solid company and is taking the right steps, but we have decided to sit this one out on the sidelines for a little while and see where things shake out after the spinoff of HCR ManorCare. While we held it, HCP was neither a big winner nor a big loser for most clients, and it paid a generous 6%+ dividend where it was held.

The proceeds from the sale of HCP were used to purchase new shares in Omega Healthcare Investors Inc. Omega Health is another leading healthcare REIT which owns skilled nursing facilities, similar to HCP but with much less baggage. Omega Healthcare has a more diverse source of revenues and has not been impacted at all by the problems of HCR ManorCare. Clearly demographics favor the industry, as an aging population will require more senior living and nursing home facilities. Omega Health's balance sheet is exceptionally strong, and it has provided consistent growth in both income and dividends over the last several years. The dividend income yield is actually higher than HCP at 6.8%, and it is very well covered. While the growth rate is expected to temper a bit looking forward, slow and steady growth is expected to continue for quite some time and the stock remains very reasonably priced. By swapping shares from HCP to Omega Health, we increased both the quality and the income yield, and we believe we lowered the risk. The biggest risk to Omega Health as well as its competitors is their dependence on Medicare and Medicaid for a large portion of their revenues. We believe that is what has kept the stock price fairly low. But changes in the ways these payments are calculated have been coming down the pike for over a decade and are not exactly unexpected. If Omega Health can continue providing even modest increases to its cash flow and growing dividends, it ought to be a successful investment.

Our other new purchase this quarter was well-known tax preparer H&R Block. Prior to our purchase, Block was a huge underperformer, down about 30% in price in an up market. We believe many of the problems with Block are temporary in nature and the stock has overcorrected to the downside.

Just over a year ago Block announced the completed sale of H&R Block Bank. Although the bank was a small piece of the overall company, the much tighter regulatory environment today required them to hold reserves well in excess of the needs of the rest of the business. By selling the bank these funds were freed up for other purposes.

In conjunction with the sale, the company announced plans for a new capital structure, which included a huge stock buyback of over 20% of its outstanding shares as well as a restructuring of the company's debt. While all of this was going on, both revenues and earnings were down for the fiscal year ended in April, which is not all that surprising due to the loss of revenues and charges associated with getting rid of H&R Bank.

Block typically runs a deficit for its first three quarters of its year and then more than makes it up for it during the last quarter of its fiscal year – tax season. So even with a bounce back in earnings this year, it will be a while before we will see significant improvements coming through in the company's long term results. Looking forward, changes to the Affordable Care Act should provide a boost in the number of customers seeking help in preparing their tax returns this year. The company is also taking steps to prove it is shareholder friendly. Specifically, Block recently increased the dividend 10%, its first increase since 2011. As it stands now, Block pays a 3.8% dividend yield, well above its own 5-year average and the rest of the stock market as well. The stock trades around 13 times earnings, well below the market averages. This is a stock that may require some patience. However, over the long run we see a great deal of potential in Block as well as a handsome dividend income flow while we wait.

H&R Block replaces Kohl's on our Top 20 list. Kohl's was sold for tax purposes in some taxable accounts this quarter, and we are yet to buy it back. Although uncertainties prevail among many conventional retailers these days, Kohl's remains a best-in-class operator with the highest gross margins in the business. We continue to hold Kohl's in many accounts and are keeping a close watch on the industry. If there is even a small bounce back in retailers, Kohl's is likely to be a beneficiary. However, as Amazon makes an ever greater push into clothing, a Kohl's staple, this is one we will continue to watch closely.

<u>Summary</u>

Both the economy and the stock market will eventually undergo significant change as stability in all things economic is generally an illusion. Economic growth is still slow, the stock market is historically high and some increase in interest rates is not far off. As long as the economy continues to tick along, albeit at a slow pace, the stock market and interest rates should be OK.

But they are all interrelated. A change in any one of them relative to the status quo could have a significant impact on the other two. Like a jet flying at slow speed, a slow growth economy can be quite unstable. However, at least for the time being, the watchwords remain steady as she goes.

Sincerely,

Loudon Investment Management LLC

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