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July 10, 2017

Dear Clients and Friends:

For the first six months of the year our equities did reasonably well. Our aggregate common stock holdings came in ahead of the returns of both the High Yield Dividend Aristocrats and the Russell 1000 Value Index but still lag the S&P 500. The latter, of course continues to be heavily influenced by low or no yield tech stocks but we did gain ground in the second half of the quarter. In general we have out-performed on days when the market is down but have lagged when tech is running and the market is up.

Your appraisal and performance are attached. Recent market returns are below:

	6 Months Ending 6/30/2017
Benchmark Indexes	
Lipper Balanced Fund Index	6.9%
S&P 500 Stock Index	9.3%
Russell 1000 Value Index	4.7%
High Yield Div. Aristocrats	5.4%
Money Fund Average	0.1%
S&P-BGCantor-7-10-year-US Treas. Bond Index	2.5%
S&P-BGCantor Twenty Year+ US Treas. Bond Index	6.0%

The return from long term Treasury bonds is somewhat surprising given the Federal Reserve Bank's current policy of increasing short term interest rates. Not only that, but it is likely that the Fed will shortly begin to unwind its very large holdings of longer term Treasury bonds. These were accumulated over a number of years as a part of their "quantitative easing" policy that was ended several years ago. This force fed money into the financial system through the aggressive purchase of Treasuries beginning in 2009. If this policy change is implemented, returns on longer dated Treasuries and other longer term bonds will be very restricted (and perhaps worse) going forward. For this reason we don't own any and believe that this year to date rally is an anomaly. The traffic light on long term bonds is flashing red.

As to the stock market, debate continues as to whether it is high or fairly valued. No one seems to want to characterize it as low and that could be important in and of itself.

Whichever proves to be true depends largely on economic and earnings progress going forward which in turn are both influenced by the level and direction of interest rates. Tight money is not good for either the economy or the stock market and though we are not there yet, we are moving in that direction. We turned the equity traffic light yellow after the Federal Reserve Bank announced that interest rates would be rising. While the debate continues on whether or not this is the right policy, increasing rates are likely to continue for some time. This was confirmed on Friday as employment statistics offered one more surprise to the upside. Full employment often adds inflation pressures to the system and inflation leads the Fed to move sooner rather than later to keep inflation under control.

Remember that it took thirty years of decline for interest rates to reach their recent lows. So the tailwind that both the economy and the stock market have had in their favor may be gone for some time.

We continue to see an increasing number of articles suggesting that it really is different this time. This may or may not be true but we doubt very much that either economic or market cycles will be any less severe than they have been in the past. The economy continues to have a green light.

Updates to our Portfolios

This quarter saw very little turnover in our top twenty list of holdings as we did not do a great deal of trading during the period. Teva Pharmaceuticals and Viacom both dropped a few spots out of the top 20 and were replaced by Abbvie and Amgen. In many ways, the stock market remains a "market of stocks" rather than the single entity as it is often characterized.

Teva was up very slightly in price for the quarter, although its overall performance has been disappointing. The company has faced a multitude of problems in recent quarters, including price erosion for generic drugs as competition has grown, potential competition for its blockbuster MS drug Copaxone, and several shakeups in its management team. In addition the DOJ has initiated an investigation into Teva and several other companies regarding possible collusion in the pricing of generic drugs. Meanwhile the company's stock price has stabilized quite a bit and the generous 4% dividend is well supported. We are not in any rush for the exit, but we are re-evaluating the stock and will likely continue to trim it back as opportunities arise. One of the reasons we continue to hold the stock is that through all their issues they have continued to generate excess cash beyond their immediate dividend and capital spending needs.

Never one of our larger holdings, Viacom has dropped out of the twentieth slot due to poor performance. It was one of our best performers early in the year, but has since given up those gains and then some, and is now down slightly year to date. Most recently the stock was penalized in early May after Charter Communications announced it would not include Viacom's lineup of channels (including Nickelodeon, MTV and Comedy Central) in its basic cable package.   Viacom's business is inherently more risky than our typical investment as media fads come and go. As consumers continue "cutting the cord" and companies like Netflix and Hulu change the way that media is consumed, it is hard to predict the winners and losers as we look forward. However Viacom is not out of the game. The company holds the rights to thousands of movie titles including some of the most popular movies ever made, its cable networks are popular with traditionally hard to reach audiences, and affiliate fees are both fairly predictable and substantial. We continue to watch the stock closely but believe it is extremely undervalued at current prices – perhaps selling at less than liquidation value.

While we have added some shares to AbbVie here and there, this long term holding broke into our top twenty based entirely on solid performance as shares were up 12% for the quarter. The company is very much involved in the world of biopharmaceuticals. This refers to companies and drugs that are produced through a biological process rather than a more traditional chemical process. This makes them more expensive to produce but may provide relief for the relatively few areas where relief has not yet been found. For instance, AbbVie relies heavily on its blockbuster drug Humira (for rheumatoid arthritis), which is also the highest grossing drug in the world. There were no big surprises over the quarter, which likely worked in AbbVie's favor as the pressure on patents to Humira continues to build. But there are a substantive number of replacement drugs in the pipeline. AbbVie's main problem is that Humira has been so successful that it will be difficult to replace. All in all a solid company, we feel comfortable continuing to hold on to AbbVie at current prices.

Our other new top twenty holding is Amgen, which supplements AbbVie as the world's largest biopharmaceutical company. We have been steadily adding to Amgen since late last year. Given our aging population we believe the drug industry is likely to continue growing for years to come, despite the high likelihood for more and more pushback on drug pricing and inroads made by generic drug companies. Of course, many investors have had the same idea. So until an industry-wide slump in healthcare stocks late last year, the prices of most potential holdings were out of reach. Biopharma companies in particular did not meet our criteria for a very long time because none of them paid a dividend. Amgen only began to pay a dividend in 2011 but has ramped it up significantly since then. The combination of a rising dividend and falling stock price put Amgen on our radar this past fall. The company offers a wide range of products that treat cancer, anemia and autoimmune conditions. Growth potential appears solid with a recent launch of cholesterol drug Repatha, which has blockbuster potential, as well as Kyprolis for multiple myeloma.   The current income yield of around 2.7% is very respectable for the industry, and the annual dividend has been increasing at double digit rates. The stock is currently reasonably priced and this is a company we look forward to holding for the long term.

Meanwhile this quarter, Coach and Tupperware have given us a great example of why we don't sell stocks just because they are down in price. Coach was a turnaround story that has taken some time to develop, while Tupperware has met all of our fundamental goals but the price has lagged due almost entirely to currency translation as the dollar continued to strengthen beyond expectations (with just 16% of sales in North America, Tupperware is more vulnerable to currency fluctuations than a typical holding. As a matter of policy they do not hedge currencies believing that over time it is cumulatively not the best use of cash flow). While both companies have had disappointing investment performance in the past, they have more than made up for it in the first half of this year – both stocks are up more than 30% year to date with double digit performance continuing in the second quarter. From their lows reached in 2015 Tupperware is up 60% and Coach up 75%.

When we have holdings that are down we are always looking for the reasons why. Often we are simply a bit early to the party as it would be nearly impossible to catch most stocks at exactly rock bottom. Short term performance does not always follow any logical path, though we strongly believe that all companies eventually come back to “fair” value range. Coach might fit into this category. We believed a turnaround was likely as new management took over and also were also willing to be patient as we knew it would likely take some time. As with Teva, both Coach and Tupperware have been consistent generators of excess cash even after paying dividends and that is always a good sign. It often means that a company does not require outside financing to implement necessary, and sometimes expensive, changes. But it also suggests that the dividend is secure. With a company like Coach if you wait for a turnaround to be a sure thing you more than likely will also miss out on the biggest gains in the stock as well. Other times companies are moving along the right path but growth is slower than we had hoped or our thesis takes longer than expected to pan out. Tupperware is a great example of this. Fundamentally Tupperware has met all of our expectations, but due to currency translation the bottom line has risen more slowly than we would have hoped. In either case, as long as our primary reasons for holding the company remain intact and the dividend looks secure, we are reluctant to sell just to relieve our own concerns as it also locks in any losses in the price. While we wait, we generally get to collect a solid dividend for our patience.

Unfortunately there are also cases where our assumptions just prove to be wrong, and that is when we really have to re-evaluate whether the company is one we want to continue to hold for the long term. Sometimes the best decision is to sell and move on to a better opportunity. We are going through this process with Teva. Last year Teva made a major acquisition to diversify their business from their earnings reliance on Copaxone (mentioned above). We believed this would make them the low cost provider of generic drugs but competitive pricing pressure has been more extreme than we anticipated as more proprietary drug companies have moved into the business. Thus we are now taking a fresh look. As many of you have taxable capital gains this year, we may sell it in those accounts and revisit the holding after the required exit time for tax purposes.

Many investors will sell a holding simply because it is down in price particularly near the end of a reporting period. This is often referred to as window dressing when funds or managers do it just to make the portfolio look better (i.e. fewer “losers”). We simply don’t do this as it often means selling low and ultimately hurts performance. Instead, we are constantly re-evaluating whether the value we initially saw is still there when our holdings are down. If we believe it is, we are much more likely to continue holding onto the stock however bad it may look. We invest with a 3-5 year time horizon in mind, which gives us an awful lot of time to ignore the noise surrounding any particular investment in the short term.

This is one reason we encourage clients to call us if there are any questions about any of the holdings in their portfolio. We are always happy to explain the logic behind any of our investments and why we may continue holding stocks no matter the recent performance.

Conclusion

Managing portfolios is a little bit like driving an eighteen wheeler on an interstate highway. Yes you can steer and brake and accidents are few in comparison with miles driven, but stopping or changing direction on a dime is out of the question. Sudden actions may have the reverse result of what is intended. In the stock market, control is an illusion. Just about the time you think you have it figured out the world and/or the market changes.

Different advisors go about coping with this in a number of different ways. Our own approach is to try to stick with high quality income producing stocks for the long term. What is the “long term”? For analytic purposes we consider what a given stock and the underlying company are likely to do over the next three to five years. But beyond this, we are risk avoiders rather than risk takers, though there are degrees of severity for both.

We believe we understand the underlying fundamentals of what we own. We also try to buy cheap and if we are successful in doing both your performance should take care of itself over time. But the last five years have been challenging. For one, the market cycle seems to have all but disappeared since the market hit its lows way back in 2009, now over eight years ago. As our best returns relative to the market averages have usually occurred during downturns, this is one of the factors that accounts for our recent lackluster performance. However we don’t think the market cycle is dead.

As we have said many times, we don’t try to time the market nor are we familiar with anyone else who has been right at market timing more than once. Rather we try to determine the best mix of risk and opportunity given each of our clients’ tolerance for interim loss. This expresses itself in a maximum equity percentage for each of our accounts or family groups. If the market does well or withdrawals push this percentage above the upper end of this range, we become incremental sellers. At a minimum we are selling “high”. But the reverse is also true. If a market panic pushes equity exposure below the lower end of our range, we step up and buy in the belief that the market will eventually move higher – we are buying low.

It is important to remember that over a large majority of five year periods, the stock market has been the best place to invest your money regardless of the start date. We avoid either panic buying or panic selling at all costs. As we are probably all aware, the pressure to buy is at its greatest when the market approaches its top (today?) and the pressure to sell is at its greatest as the stock market approaches its panic lows (2009). And since we opened our doors in 2002, this fact has stood us in good stead.

Having said all of this, we urge anyone who has questions about their level of equity investment relative to total account size to give us a call. Peace of mind is also a valid and important client objective.

Sincerely

Loudon Investment Management, LLC

DML/ELS/JJS