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Dear Clients and Friends:

As was the case in the second quarter of 2017, our aggregate performance for the last three months fell between the S&P 500 on the high side and the Russell Value 1000 on the low side. These results are in line with what our accounts are designed to do: underperform the general market when stocks are rising strongly but hold on to more of your money when stocks in general are falling. In spite of our performance over the past three years, since we opened our doors for business, our equities have outpaced the S&P 500 by a comfortable margin after a deduction for our fees.

As always, your September 30 asset appraisal and performance are attached. This year's bond and stock market performance is detailed below:

	9 Months Ending 9/30/2017	3 Months Ending 9/30/2017
<u>Benchmark Index Returns</u>		
Lipper Balanced Fund Index	10.2%	3.1%
S&P 500 Stock Index	14.2%	4.5%
Russell 1000 Value Index	7.9%	3.1%
High Yield Div. Aristocrats	8.9%	3.3%
Money Fund Average	0.6%	0.2%
S&P-BGCantor-7-10-Year-US Treas. Bond Index	4.4%	1.9%
S&P-BGCantor Twenty Year+ US Treas. Bond Index	2.9%	-2.9%

It is interesting to note that long term Treasury Bonds actually declined in price more than the income earned. This is the first time this has happened in a while but it will continue over time as long as the Federal Reserve Bank continues to push interest rates higher. This is the reason we own almost no long term bonds.

The Financial Markets and the Economy

“Bull-markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria.”

John Templeton

John Templeton was one of the great contrarian investors of all time. Like Warren Buffet, he also left behind many “quotables” and the above seems particularly relevant today.

So where are we today on a scale running between pessimism and euphoria? The action of the stock market alone would suggest that we are somewhere between optimism and euphoria as many pundits point out regularly. But skeptics abound. Skepticism is the so called Wall of Worry that bull markets are often said to climb and, though mostly ignored, there has been plenty to worry about.

The fact is that much of the confusion has to do with time frame and market psychology. In the short-term markets can do anything, rational or not. On a daily basis new facts are few, so price moves are almost always psychologically based. But longer term, it is mostly earnings and interest rates that drive stocks higher or lower. Today we have a growing economy, providing the backdrop for growing earnings and low interest rates. The result is nirvana, at least as long as it lasts.

There is really no complete theory of the financial markets though from time to time, economics or business professors claim to have found one. The problem is that emotions can't be quantified with any precision. Emotions almost always outrun the facts but are generally unpredictable and unsustainable. For instance, how can we quantify the psychological impact of the Trump administration's foreign policy? How much impact is it having on the market? Or how much should a stock decline if it disappoints on reported sales or earnings. We just don't know.

That is why individual securities and markets become either over or under valued. Misinformation, intentional or not, just adds to the confusion. Stir in a few computer algorithms to allow program traders to buy or sell large buckets of securities with certain characteristics at the push of a button and you have the markets we see today... and we haven't even gotten into the impact of derivative securities. No wonder there are lots of skeptics in the stock market. But at least for the moment they all seem to be hanging on and successfully climbing the wall of worry.

For us, this situation produces both opportunities and risks. The more that individual stocks move away from fair value for non-fundamental reasons, the wider the margin of safety in drawing conclusions about where prices will be in the future.

The two measures we do rely on to point us in the right direction are economic growth and interest rates. Economic growth is straight forward, as it translates into more assured earnings growth on the corporate level and more earnings growth translates into higher stock prices over time. A company that earns more is worth more than one that earns less.

Interest rates, however, are more subtle. Money has to go somewhere and the less that is earned from money funds and bonds, the more likely that money will be invested in the stock market driving prices higher. This is a major reason why the stock market today is valued at 20 times earnings or more while the long term average is about 15 times. If interest rates go back up, the valuation of the stock market will decline and in some cases this can overpower rising earnings resulting in a declining stock market.

At the moment we have a green light on the economy (and by proxy on corporate earnings as well) but a yellow light on stocks. There is likely to be another small hike in interest rates before year end making this the third this year. While absolute rates remain quite low, sooner or later the rising rates will have an impact on stocks and we expect the Fed to continue its policy of measured but fairly regular increases.

Portfolio Highlights and the Amazon Effect

There were no significant changes in our top 20 holdings over the quarter. Fastenal dropped out of our top holdings as we began trimming it back in accounts where the position is large or we have been able to find better opportunities to buy. Fastenal was replaced on our top 20 list by Caterpillar which had stellar performance for the quarter, up over 19%.

Fastenal is a wholesale distributor of industrial and construction supplies. Under the Fastenal name it offers a multitude of fasteners (bolts, nuts, screws, studs, washers, etc.) as well as various products and hardware (such as pins and machinery keys, concrete anchors and wire ropes to name just a few), which are used in manufacturing products and building supplies as well as other industries. Fastenal operates its business through about 2,500 company-owned stores. The business has expanded to vending machines, inventory-management services, and most recently an onsite program. Fastenal is able to gain market share from other distributors largely due to its broad product portfolio and inventory management system. Additionally their “vending machine” offering have proven popular for onsite access to common building supplies and has plenty of room to grow.

Initially purchased about two and a half years ago, Fastenal has been a moderate investment for us with few surprises along the way. The price has increased a bit from our initial purchase and was up for the quarter, though it sits off its high set earlier in the year. The dividend has had reasonable increases of about 7% annually since purchase. The company is in excellent financial shape with almost no long-term debt, and moderate increases in cash flow and earnings are expected over the next several years. An unexciting company, there is still a lot to like about Fastenal. Under normal circumstances this would be an ideal stock to hold for the long term.

Yet as we evaluate any retailer today, it is impossible not to consider how Amazon is moving more aggressively into the space. You surely have heard that many of our malls are struggling, and perhaps you see fewer people walking through the aisles in your own local stores as more and more items can be found online. From diapers to auto parts and office supplies, Amazon now plays a role in regular purchases that goes well beyond standard retail customers. There are whispers that online drug sales are next. And in a more recent shift in strategy Amazon is making a push into physical retail with its purchase of Whole Foods as well as an announcement that they will be testing out having a physical presence (“store within a store”) inside several Kohl’s locations.

A true disruptor, Amazon has changed the way we purchase goods. Amazon is clearly *the* dominant player, but it is only within the last year or so that the company has been able to turn its growth into any

meaningful profit. Priced around 200 times earnings, Amazon will need to begin showing some significant and persistent profits soon to justify the current stock price. This may prove to be a difficult feat, though it does have momentum on its side along with a voracious appetite for continued growth. Potential headwinds for Amazon could revolve around larger competitors pushing back – while initially caught with their heads in the sand larger competitors like Wal-Mart are now strengthening their online offerings. Also as Amazon continues to grow, it will likely push up against the dreaded label of “monopoly” if it drives too many competitors away. This ultimately could impact its ability to conduct normal business or make acquisitions, particularly in Europe which tends to implement much stricter regulations than the U.S. Although Amazon stock has never been a contender for us to purchase due to the fact that it pays no dividend, we do plan to keep a close watch on how the Amazon effect continues to play out over time.

Meanwhile it is difficult to look at any company or product without wondering whether Amazon may have an impact on its business over the next several years. With this in the back of our minds we ponder the future of Fastenal and worry a bit about its future growth along with other retailers. Amazon began pushing into Fastenal’s space in 2012 with the launch of Amazon Supply (now Amazon Business). To date Amazon has not proven to be much of a direct threat to Fastenal. But as with just about any distributor/retailer, there is at least a possibility that could change quickly. Fastenal distinguishes itself by its size and breadth of product offerings. There is little doubt that Amazon could steal some market share if it were to pursue the sector aggressively or act as a distributor for Fastenal’s competitors. While we are not in any hurry to clear a high quality company that meets all of our criteria off the books, we are taking the long view and trimming the position where it makes sense to do so.

Tax Reform or Tax Cuts?

Economic growth, simplicity, greater equity between different earning levels and a broader tax base are the four main goals set forth for tax reform. This is far more complex than just talking about just cutting taxes.

Tax cuts alone would be a much easier path as it would focus on reducing or adjusting the current tax rates a few percentage points for all individuals. But just implementing cuts would not solve our problem of having a much too complicated tax code with loop hole after loop hole. In essence tax cuts would simply be an attempt to make constituents happy without addressing the real issue of the complexity of the tax code.

What are the proposed changes for individuals?

- It would reduce the number of tax brackets from seven currently to just three.
- The standard deduction would be doubled eliminating the need for many to itemize.
- All deductions, except those for mortgage interest and charitable contributions would be eliminated and limits may be set for the two that remain.
- The much hated and complicated alternative minimum tax would be eliminated.
- The option was left open for a surtax on the earnings of “super-earners”.
- The estate tax would be eliminated.

- Personal exemptions would go away in favor of selected tax credits for those who need them.
- Taxes on dividends, interest and capital gains would remain the same.

That is a lot to swallow in one bite. The business tax changes are less emotional and somewhat simpler. In addition, the corporate income tax makes up only about nine percent of federal revenues (versus 47% from personal income taxes) so any changes will likely be much less controversial and probably have much less an impact on projected budget deficits.

The business tax currently sits at 35%. However, the landscape is not an even one as, depending on the nature of their business, some corporations can use a lot of deductions while others are just not eligible. For instance, heavy manufacturers, energy companies and miners generally pay much less in taxes per sales dollar than a software company. Deductions available to companies with heavy capital requirements simply don't apply to capital light companies. The objective of removing some deductions (increases taxes for those not paying much today) is to simplify and create a more level landscape while reducing the aggregate tax rate to something around 20%. This would also make our tax rate much more competitive with other countries with lower rates.

There may also be a special limited time further deduction in taxes owed for companies with money currently "trapped" overseas due to our high tax rate compared to lower rates there. Ireland's rate is 15% compared with our 35%. This encourages companies to build more facilities there because the company has more money to spend if it stays in Ireland rather than being brought back to the U.S. where it would be subject to more taxes. The hope is that if money flows back to the U.S., it will spur more domestic investment, leading to more jobs, growth, etc.

So when we add both revisions up what do we get? We like the corporate tax changes which both improve tax equity between different kinds of companies and also make us more competitive with foreign companies based in lower tax venues.

But the change in individual tax rates and provisions is both more subtle and complicated. For Instance, while many articles have already been written pro and con, the income levels at which the three new rates for individuals will be set were not laid out in the outline and have been left up to Congress. This is never a good thing to do in today's highly partisan world although it does provide more wiggle room for negotiations. But, until the income levels are set, none of the many projections we have seen on the impact of the law have any meaning at all. Fortunately, there are a number of possible tradeoffs between the left and the right which should be helpful in developing a consensus sufficient to pass the legislation.

As with all things tax, there are also provisions that automatically raise the hackles of each side in the debate. A good example is the elimination of the estate tax. Whether or not this survives in a final bill - it has been suggested but always eliminated in past legislation - remains to be seen.

The pro-growth argument in favor of legislation comes from the assertion that all the proposed tax reductions will eventually pay for themselves through increased economic activity. A large portion of the taxes not collected will remain in the hands of those with an above average propensity to spend as

they need the money for ongoing living expenses. More spending means more economic activity and therefore faster growth. As a result, there is no question that done properly, some portion of the taxes lost through the rate reductions comes back as growth picks up. However, how much is an impossible number to quantify with any precision. As a result, most of the analysis that comes from nonpartisan government groups uses what is called “static analysis” that ignores the psychology of the cuts. People feel better with more money in their pockets. How people feel matters. Yet, no credit is given for the payback created from increased growth and the higher tax collections it produces. With static analysis the deficit numbers balloon higher in spite of the fact that all understand tax revenues will be higher if growth picks up. What it does do is create a great partisan deficit debate with no resolution likely.

Having said all of the above, all politicians like tax cuts. Some however, and with some justification, worry more about the near term impact on tax revenues until growth picks up. Even with this conflict, assuming some bipartisanship, something will probably pass and be signed by the President but the final configuration, particularly on the individual side, is anyone’s guess.

Conclusion

So other than what seems to be ongoing strength in the economy, the picture is confused. This is not unusual as none of us can tell what piece of news will begin to move the stock market or its psychology in another direction. Tax changes only add to the confusion though the corporate cuts, if enacted, are very likely to result in higher earnings. Simply to say that the market is too high doesn’t capture anything close to all the moving parts we have, though we all know that one day the market will be deemed too high.

Having said all of this, our long term asset allocation guidelines relate far more to your individual needs than any strongly held belief that the stock market is too high or too low. In relation to this, we have done some trimming when we believe the equity position of an account has become too high. On the equity side, we will continue to try to find high quality companies selling at historically high dividend yields with favorable prospects for long term growth in the future. For the time being, this will keep us from enjoying all the benefits of a roaring bull market but as has happened so often in the past, should also provide some comfort when the market starts to move in the other direction.

Just give us a call if you have any input or questions.

Sincerely,

Loudon Investment Management, LLC

DML/ELS/JS/LO