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Dear Clients and Friends:

Re: Q1 Investment Review

In the first quarter our client performance ran pretty much true to our approach. Last year when the market ran into its funk and was down some 20% top to bottom, our aggregate decline was much better with a total return 5 percentage points better that the S&P 500 at about -15% from the September high to the December 24 low. In contrast, from that point through the end of the first quarter, with the S&P up 21%, our accounts returned about 15% in aggregate.

As much as we would like, we can't have it both ways – both rising faster than the market when it is going up and declining slower when the market goes down. Given a choice, we have generally opted to lose less on the way down. Additional comments on this subject may be found at the end of this memo.

The first quarter total returns from the markets are below.

Benchmark Index Returns	3 Months Ending 3/31/2019
Lipper Balanced Fund Index	8.5%
S&P 500 Stock Index	13.6%
Russell 1000 Value Index	11.9%
Money Fund Returns (Current annualized rate)	2.4%
S&P -7-10-Year-US Treas. Bond Index (TR)	2.4%
S&P- Twenty Year+ US Treas. Bond Index (TR)	4.7%

Back in September of last year the stock market hit its all time high. It then proceeded to decline just about 20% through December 24. From there we have since moved strongly higher so that we are rapidly approaching the September high, and it wouldn't be surprising if we go on to a new all-time high.

Is this the restart of something old (the bull market continues) or the beginning of something new (the top of the market)? Of course, there is, as almost always, evidence to support either case.

On the positive side, the rally back has been very impressive in its strength as well as the breadth as, this time around, more than technology was pushing the index values up. And fundamentally strong renewed job growth has just been announced for March along with a 3.8% unemployment rate. There appears to be a job available for anyone who wants one.

But on the other side, unbridled enthusiasm seems to have diminished somewhat and earnings estimates are being reduced. We are hard pressed to understand why projected 2019 earnings were so high to start with as the whole world knew that the special boost last year from tax cuts would not be repeated. It remains to be seen whether further earnings markdowns are ahead.

The economic expansion seems to be continuing, although, perhaps at a somewhat lower rate. Following soft numbers in February and the earnings markdowns, there is now much more conversation on a possible recession in 2020. Brexit, trade negotiations with China and the immigration dispute with Mexico are all wild cards for this year and next.

The Federal Reserve Bank has turned decidedly more dovish with respect to future rate hikes and there is now even some talk of a rate reduction. Today the Federal Funds Rate (the base interest rate from which all other U.S. rates are derived) is 2.5% or just about in line with last year's official inflation rate of 2.4%. This is generally considered a "neutral" stance implying that very short-term interest rates are just offsetting the economy's inflation.

The same, however, can't be said with respect to longer term rates as ten-year U.S. Treasury securities aren't yielding any more than Fed Funds, generally a factor of concern as it means that demand for longer term funds (for corporate expansion) is no greater than for shorter term funds. What we don't know is whether or not, in the current low interest rate environment, that this has the same meaning as it has had in the past when rates were generally higher. And we also don't know the real impact the unwinding of Quantitative Easing is having on "normal" longer term interest rates.

There are many extraneous forces now at work in the bond market, most a result of the so-called Quantitative Easing policy that we believe went on far too long. The result of the unwinding of this very stimulative monetary policy has been, among other things, a distortion in normal bond market behavior and relationships during economic expansion. That particular program remains very much an "experiment" in play though the policy itself has been discontinued. No one really knows what, if anything, all this will lead to but the flat yield curve has been a major topic of discussion on the pundit circuit.

First Quarter Activity

All in all, we were not very active traders during the first quarter. As a result, we had no stocks move on or off our top twenty list. Overall it was a great quarter for stocks, and that came through in our top holdings as well - fourteen of our top twenty holdings had double digit returns, and five holdings returned greater than 20%.

Our worst performer year to date is AbbVie, originally the pharmaceutical arm of Abbot Laboratories that was spun off several years ago. Our only holding in substantially negative territory, AbbVie stock lost about 11% in value during the first quarter. AbbVie fell in late January based on an earnings report that fell slightly short of expectations on both earnings and revenues. In particular, sales of its blockbuster drug Humira were down nearly 15% overseas due to new competition from biosimilars. Although this news is not unexpected (investors have been aware of upcoming competition for Humira for several years), the news did serve to spook at least some investors. Meanwhile, at current prices we continue to like AbbVie stock and would consider adding it where it isn't already owned.

Top Twenty Holdings Q1 Return by Security

Cisco Systems Inc	25.29%	PepsiCo Inc	11.77%
Fastenal Co	23.81%	AT&T Inc	11.67%
Ameriprise Financial Inc	23.60%	Pebblebrook Hotel Trust	11.06%
VF Corp	22.54%	Aflac Inc	10.34%
Enterprise Products Partners	20.11%	Caterpillar Inc	7.30%
Microsoft Corp	16.57%	Qualcomm Inc	1.30%
Starbucks Corp	15.99%	DowDuPont Inc	1.08%
Intel Corp	15.10%	Amgen Inc	-1.66%
Illinois Tool Works Inc	13.90%	Pfizer Inc	-1.88%
Ventas Inc	12.21%	AbbVie Inc	-11.42%

Despite the "bad" news, sales of Humira were up overall in 2018, just shy of $20 billion. Used for the treatment of autoimmune disorders like rheumatoid arthritis and Chron's disease, Humira is the best-selling drug in the world, and it isn't going away anytime soon. Due to patent settlements in the US, sales over here should continue relatively uninterrupted for the next five years. Meanwhile, AbbVie management has focused on diversifying into other drugs. Cancer fighting drug Imbruvica and Hepatitis C drug Mayvret now make up over 20% of sales, and their numbers continue to grow which should help to offset potential future losses from Humira. Meanwhile, earnings per share for AbbVie were up over 40% in 2018, and the dividend was recently increased by 11%. The current yield for this dividend aristocrat is high at over 5%, and the dividend is well covered by earnings and cash flow.

At current prices, we believe the bad news is well priced into the stock, and don't mind holding onto existing shares.

Our one concern that relates to all drug companies is the potential at some point for the US Government to intervene in drug pricing, and this is not likely to go away anytime soon. The most susceptible drugs in the short term appear to be the ones that treat chronic illnesses for which acceptable treatments have been available for a long time. Insulin and epi-pens are the two that are frequently mentioned in the press. With a focus on much more specialized and newer medications, AbbVie's portfolio may be somewhat less vulnerable to these attacks than other drugs in the short term, but it is something we keep a close eye on. Nevertheless, even with a few dark clouds swirling around, we believe high quality AbbVie is a bargain at current prices.

Rounding out our "worst performers" list for the first quarter are Amgen and Pfizer with slightly negative performances. This isn't too surprising, as health care was the worst performing sector for the first three months of the year. There doesn't seem to be any particular news holding these companies back as there was with AbbVie. The sector is considered defensive, meaning these companies tend to hold up relatively well when the stock market is going down. Additionally, Pfizer and Amgen both had stellar performance in 2018. Both stocks finished the year well ahead of the S&P 500, and as expected held up particularly well during the last quarter when the market took a dive. We are willing to be patient with these high-quality holdings.

Shifting gears towards our winners, our best performers for the quarter were Cisco (+25%), Fastenal (+24%) and Ameriprise (+24%). Although these companies are in very different industries (technology, industrial, and financial), their stories are actually quite similar. All had great years in 2018 from an operational standpoint, with record revenues and earnings as well as solid dividend increases (though Ameriprise stock was a laggard in 2018, while the other two came in ahead of the S&P500). Although we are keeping a closer watch on these companies that are all trading far higher than where we bought them, none of them meet our criteria for "grossly overvalued" which would indicate the need to sell, and we do not have any great fundamental concerns at this time. We have trimmed Cisco and Fastenal from time to time in cases where they have grown too large relative to portfolios.

In other portfolio news on April 1 another of our top holdings, DowDuPont, spun off its Materials Science Division into a new stock and separate company that will retain the Dow name. Shareholders received one share in the new company for each 3 shares owned in DowDuPont. Ultimately the company is splitting into three pieces, a process that is expected to be completed within the next several months. The Agricultural Division will be called Corteva Agriscience, and the Specialty Products Division will be named DuPont. DowDuPont stock hasn't gone much of anywhere recently, and it appears many investors have taken a wait and see approach. While we expect some fluctuations, so far the spin-off has been well received with the new Dow stock up about 9% since the spin-off was completed less than a week ago as we write this, while DowDuPont is also up a little bit. We expect that we will make some changes to our holdings as the breakup is completed, but for the time being we remain cautiously optimistic about both stocks.

Conclusion

In a "normal" market cycle we would expect that we are at the tail end of the great bull market, that by some definitions, began way back in 2009. But this market has broken so many precedents that we can't argue that point with any kind of conviction. We do know that the market is historically high and that many of the newer companies, particularly technology companies, are way overpriced unless very high earnings and sale growth rates are maintained for a long time. In the technology sector this extends to many large companies as well. Earnings growth and economic growth remain healthy but are likely to be slower than in the recent past.

Our approach to investment management has always contained a strong dose of risk avoidance but in a roaring market, risk is forgotten until it rears its ugly head again. Last fall, we did get a reminder of how quickly the good times can be interrupted and that was when our performance relative to the general stock market was at its best. Whenever the market does decide to move lower on a more sustained basis, our accounts and our stocks should hold up much better. We believe this approach is consistent with the expectations and objectives of most of our clients, but it can be very frustrating while the market is going up.

We acknowledge that we have made some mistakes in selection along the way and have since implemented procedures that we hope will keep the big losers to a very limited few. A few of these seem to randomly appear in all portfolios from time to time but the market today seems hyper sensitive to anything less than very positive news. We assume this is largely spurred on by the amount of dollars now devoted to formulaic or logarithmic trading. This spurs immediate activity and explains why otherwise very good companies lose 10-20% of their value on minimal disappointing news.

The SEC, as is often the case, is well behind in its oversight of this kind of activity and the fact that it is not very well monitored or disclosed needs to change. The stock market is not there just to make money for speculators but is a critical part of the capital fund-raising mechanism by which both new and more mature companies have the ability to raise funds for expansion and future growth.

What none of us know is what role the Quantitative Easing policy implemented by the Federal Reserve Bank has had in pumping up the market in addition to supporting the economy. When more than enough money is available to fund real economic activity, the rest sits in the financial markets and some of that works it way into the stock market creating a market that rises more than it would if it were just capturing activity in the underlying economy. Now that Quantitative Easing has ended, how disruptive will this be to the "virtuous circle"? A rising economy spurs on the market creating a belief that it won't end and pushing the market even higher. It is just at these times we should be most suspicious.

For our part, we will continue to participate in, but will likely not lead the returns from the general market, though we should generally remain ahead of our Balanced Fund benchmark as the market goes up. Our time will come when the economy slows, an over ebullient attitude is reigned in and as a result, the stock market levels off from the extraordinary returns seen over the past five years.

As always, we remain bullish on America and its stock market but a dose of realism in expectations is always useful from time to time to keep everything in perspective.

Sincerely,

Loudon Investment Management, LLC

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