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Dear Clients and Friends:

Happy New Year and may we have more like 2019! All the major equity indexes returned over 20% last year – let the good times roll. If there has ever been a Goldilocks environment for common stocks, we have been and remain in the midst of it, but there are always a few bears hanging around so we shouldn't get too comfortable.

And, as shown below, it was a pretty good year for bonds as well.

Benchmark Index Returns	3 Months Ending 12/31/2019	Year Ending 12/31/2019
Lipper Balanced Fund Index	5.20%	19.50%
S&P 500 Stock Index	9.07%	31.5%
Russell 1000 Value Index	7.41%	26.50%
Bloomberg Barclays 1-3 Month T-Bill	0.38%	2.38%
S&P-7-10-Year-US Treas. Bond Index	-1.32%	8.37%
S&P U.S. Gov & Corporate 20+ Year Bond Index	-1.98%	18.94%

One of the reasons last year was so good was that the end of 2018 was close to a low point in the market correction, so we had what was then a more reasonable valuation of stocks as well as continued growth in corporate earnings. In fact, the two-year average return for the S&P 500 comes out to about 12% annually which is a lot more reasonable, and it is much more consistent with the fundamental progress that companies have actually made over the past couple of years.

So, what comes next?

The economy couldn't be much better. Some have called it the best we have seen in fifty years. Most impressive has been the growth in employment that has extended itself to almost all segments of society. The result has been some of the lowest unemployment rates we have ever seen. When this kind of economic momentum gets started, in some ways it becomes self-fulfilling. And at least for some period of time there is a psychological lift as well – people just feel better and this is reflected in high levels of consumer confidence.

More people employed means more people with money to spend. When it is spent more demand is created for the goods and services bought. That in turn leads to more jobs and more industrial spending to increase capacity to produce more of what people are buying, and so on until it runs out of steam or into constraints such as inadequate supply.

So, the economy gets a grade of A+ for the moment and is now highly likely to continue on a positive growth track this year as well. If a slowdown does show up, it will probably be caused by wage and price increases that push inflation higher. Wage growth has picked up quite a bit over the past two years and is eventually passed through to what is charged for goods and services. The Federal Reserve typically reacts to higher inflation by raising interest rates to cool things down. And the stock market reacts to Fed tightening by losing value.

As investors become more sensitized to this, it is likely that the market will become more volatile. The result could be a short-term correction at any time. By definition, the difference between a bear market and a correction is that the latter declines by less than 20%. But while it is going on it can be very uncomfortable as no one knows when it starts whether it is a 5% correction or a 19% correction or something worse. We should always be psychologically prepared whichever direction the stock market decides to move in the short run.

The 2020s

If equity returns over the last decade can be described as some of the best ever, what will happen in the twenties? In the past decade, broad market equity indexes returned over 13% annually or about 11% after adjusting for inflation. The long-term average for inflation adjusted returns from stocks is about 6.8%. Has anything really changed so much that we have moved to a permanently higher return plateau? For a variety of reasons most professionals don't think so, and we agree with this assessment. Much of this conclusion has to do with simple demographics – more people are retiring than those entering the work force notwithstanding the recent employment surge.

On this basis alone, predictions for equity returns are considerably lower than we experienced in the past decade. This occurs as the high valuations accorded stocks over the past five years or more begin to gravitate back toward historic levels. Earnings growth also slows because of the demographic picture – there are fewer people in the work force and retirees just don't buy as much "stuff".

However, this does not mean that equities won't still come out on top when the decade closes out. It just means that those who are counting on 10% nominal returns per year from stocks are likely to be disappointed. Gravitation to the long run average returns has strong historic support.

It also should be remembered that we have been in a bull market for bonds as well as stocks for several decades now. Interest rates peaked way back in the early eighties and have generally been declining ever since to the point that very short-term rates in the U.S. are close to zero. In a number of other countries they are actually negative. The level and direction of interest rates has played a critical role in driving the equity markets forward as lower interest rates mean a lower hurdle rate to convince people to buy stocks.

If normalization of corporate growth (slower), inflation (higher) and/or interest rates (higher) does occur during the twenties, equity returns will moderate. The realization that we are no longer in nirvana could have a major psychologically based downward impact on stock prices once it is realized. The stocks that rose the fastest on the way up often end up leading the way on the way down. Technology investors should be very careful in spite of strong earnings growth that is likely to continue.

Technology stocks have been heavy drivers of equity returns over the past five years. We are underweighted versus the market and given where current valuations are, likely to remain that way unless there is a substantive correction. What we do own, we like and the performance of these stocks has generally been very good. But they have not been spectacular like a limited number of very large low or non-dividend paying companies – Apple, Amazon, Facebook etc. – that have been pushing the overall market up. The five largest companies in the S&P today are all technology or social media stocks. This too will eventually normalize. The technology sector is now about 23% of the S&P 500 by market weight. And this is after stripping out from the technology sector a number of technology dependent companies (Amazon is now lumped in with department stores) that made it even larger. In this sense, the market is unbalanced.

Energy today is about 4.3% of the S&P. It too was once over twenty percent of the market. At the time it was considered unstoppable as inflation rose and energy prices with it. Shale oil was just a theoretical possibility. So owners with unbridled enthusiasm for technology should act with some humility and caution.

As always, we have no idea on the timing of “normalization” but we have high confidence that it will eventually occur. Just as the stock market leveraged corporate growth and the value of earnings on the way up, so too can it be leveraged in the other direction even if all that happens is “normalization” of the factors we have discussed.

Top 20 Holdings

AbbVie Inc.	Illinois Tool Works Inc.
Aflac, Inc.	Intel Corporation
Ameriprise Financial	Leggett & Platt, Inc,
Amgen Inc.	Microsoft Corporation
Archer Daniels Midland	Pfizer, Inc.
AT&T Inc.	Polaris Industries Inc.
Cisco Systems, Inc.	Qualcomm Inc.
Emerson Electric Company	Starbucks Corporation
Enterprise Products Partners L.P.	V.F. Corporation
Fastenal Company	Ventas Inc REIT

You probably already know that as slow and steady value investors, we do not generally see a lot of turnover in our top twenty holdings from quarter to quarter, and the most recent one was no exception. This past quarter the changes to the list were all related to relative performance. Emerson and VF Corp both came back into our top twenty due to high returns, while Pebblebrook and Whirlpool dropped off our list after mediocre quarters without much price movement.

These stocks and others are all on our list as possible sales though for various reasons. One of the most difficult parts of investing is determining when to sell, so we thought we would walk you through our logic with these sell candidates. Stay tuned in 2020 to see which ones make the final cut as it is likely we will make some moves, but unlikely that we will sell them all.

1) Emerson Electric – A Fortune 500 company and dividend aristocrat, Emerson produces a large number of products and systems for commercial, industrial and consumer use. Purchased about four years ago, performance has been solid with the stock price up a little over 75% since our initial purchases. By all measures, Emerson is an A+ company with a bright future. But the valuation is somewhat high and any continued increases could push it into "grossly overvalued" territory, which is generally our signal to consider a sale. As a result, Emerson is on our watch list, though as a company with strong fundamentals we are in no rush to sell.

2) VF Corp –An apparel producer of North Face, Smartwool, Timberland, and Vans among other products, VF Corp is another company that has not disappointed with the stock up about 40% last year. VFC is also a dividend aristocrat, and its fundamentals are about as good as it gets in the apparel business. Additionally, with the future of retail at least somewhat in flux, we like the idea of owning brands rather than retail stores. However, VFC is a highly cyclical company and all apparel companies are subject to fast moving fads. At current prices it is nearing our definition of "grossly overvalued". As a result, we are inclined to take the gains and find something else to buy with the proceeds where we can (recently beaten down and previously held Kohls is a candidate that has come to mind despite its obvious retail presence). We have been trimming and selling VF over the last few months, and we expect this to continue in coming months.

3) Pebblebrook – Hotel REIT Pebblebrook had a busy year in 2019, in particular digesting its acquisition of an equally sized company, LaSalle Hotel Properties. While the stock was down slightly in price for the year, the dividend made up for the loss leaving the overall performance just about flat. After a strong runup, REITs in general have experienced a correction. While we believe the stock is undervalued and believe in the story of Pebblebrook, particularly if the economy remains strong, we have recently been finding some possible swaps with similar potential upside in the real estate sector, but with less risk. While we believe in the future of Pebblebrook and are not in any rush to sell, if we can find a higher quality and higher yielding substitute, that is a swap we would be willing to make.

4) Whirlpool – Whirlpool is a stock that has given us a bit of whiplash during our brief ownership. When purchasing we knew the stock could be highly volatile and so only bought a small amount in many accounts. Just after our initial purchases the stock went down due to fears about appliance tariffs and trade wars in late 2018 (this was also in the midst of a market correction). But in 2019 Whirlpool stock made quite a comeback, up around 40% including the dividend. Overall it has been a successful holding, particularly for one that is, by our measures, short term. It's always tough to know what to do with a company when the gains come so quickly. The stock is nearing sell territory in some regards, but it isn't there yet. In fact, the future continues to look bright for Whirlpool even after we consider the recent gains. Now that the holding is long term in most accounts, selling or trimming back is a definite possibility, particularly where it has grown to be a larger holding.

The Stretch IRA has changed

Tucked into the recent $1.4 Trillion spending bill passed and signed just a few weeks ago by Congress was a piece of legislation called the SECURE Act (Setting Every Community Up for Retirement Enhancement). Under the old rules those who inherited qualified retirement accounts, including IRA's and 401(k) plans, were able to stretch distributions over many years. For instance, someone today aged forty could spread withdrawals over their entire lifetime (thirty years or more). This provided a significant tax benefit for those with the largest IRA and 401(k) balances. Under the new rules, most non-spouse beneficiaries of these accounts will need to withdraw all funds from the account within ten years of their receiving them. There are no required minimum distributions over the ten-year period, but the account balance must be brought to zero after the 10th year. Roth accounts are also affected, though the impact will be less for beneficiaries because these distributions are already tax free. If there is any good news in this, it only applies to newly inherited retirement plans, not those that have already been set up.

In a rare feat, these changes received widely bipartisan support in Washington. Tax collection will generally be accelerated under the new rules, and as an added bonus for government tax revenues, at least some of the distributions will be taxed at a higher rate. Larger distributions will push more beneficiaries into a higher tax bracket, so the total taxes collected will increase. The impact will be greatest on the largest IRA's. Smaller IRA's already tend to be cashed out within a few years, so the impact there is minimal.

There are a few exceptions to the new rules. Spouses, disabled and chronically ill beneficiaries, and those who are not more than ten years younger than the original account holder, such as a slightly younger or older sibling, are all exempt. Minor children (but not grandchildren) are also exempt but only until they reach majority age. Lastly, the new rules only apply to those who die in 2020 and beyond, so, as mentioned above, if you are currently stretching out distributions for an inherited IRA you are exempt from the new regulations.

This is not an exhaustive list of changes. In addition to other moves, the new rules slightly increased the age at which an individual is required to take a required minimum distribution (RMD) to 72. As always, any changes in IRA accounts of any sort are extremely complex so if you have questions please give us a call and if we don't have the answer, we will try to send you in the right direction.

Conclusion

In this note we have talked about both where we are now and laid out some of the groundwork for what is likely to happen next. Over the next year or so, our concerns are limited though, as always, a correction can happen at any time and under any circumstances. But longer term our concerns are greater.

A simple return to normal levels of inflation, interest rates and equity valuations could result in significantly lower returns over this decade with at least one bear market along the way. Aggregate corporate earnings are also unlikely to grow as fast as they have recently. As long-term investors, we are not given to dramatic short-term moves but we do try to adapt with the times as they evolve.

As shown from our list of top twenty stocks, at the present time we are heavily weighted toward high quality and consistency. Our move in this direction, though impeded by the large size of taxable gains in many accounts, has been underway for several years. Other than several cases of high valuation we are quite happy with what we own. But these moves have added some degree of protection against high volatility in down markets.

Market “normalization” has and will happen over time. Of this we are convinced. We need to remind ourselves that the returns of 2019 are not likely to happen again for a long time. The last time it occurred was over a decade ago. As Warren Buffet has said, “when the tide goes out, we find who has been swimming naked”. Today the markets may be close to high tide.

Sincerely,

Loudon Investment Management LLC

DML, ELS, JJS, LO