Loudon Investment Management, LLC
24 Airport Road
West Lebanon, New Hampshire 03784
Phone: 603-298-7370
FAX: 603-298-7375
Email: LIM@loudoninv.com

Douglas M. Loudon, CFA Emily L. Sands CFA John J. Sands, CPA Lynn O'Mealia

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Dear Clients and Friends:

Re: 2020 Year-End Letter

Even though we are all glad to see 2020 now in the rear-view mirror, at least the stock market ended higher than even the most optimistic estimate at the beginning of 2020, even before Covid was a known threat. But as usual there were a number of bumps and bruises along the way. New highs for the market were reached in early to mid-February from which stocks plunged over 30% in just over a month's time.

But from there stocks began to climb the so-called Wall of Worry increasing in value substantially from the low, eventually ending up about 18% higher on the year, at least as measured by the S&P 500. The stimulus helped but in our view, excess money in the system was the primary cause rather than robust expectations for the future.

Benchmark Index Returns	Quarter Ending 12/31/2020	Year Ending 12/31/2020
Lipper Balanced Fund Index	9.40%	13.30%
S&P Dividend Aristocrats	7.80%	8.37%
S&P 500 Stock Index	12.20%	18.40%
Russell 1000 Value Index	16.30%	3.17%
3 month US Treas. Bill Yield*	0.92%	1.54%
S&P-7-10-Year-US Treas. Bond Index	-1.29%	10.05%
S&P U.S. Gov & Corporate 30 Year Bond Index	-4.07%	18.88%

*Yield at start of period

The greatest upward move of the year for stocks occurred in the fourth quarter. Is this going to continue or is change in store? It may be the latter as the Covid vaccine will be largely distributed by mid-year and there are hints that interest rates may have started to rise from the historically low yields

of last year. The latter may be pushed higher by a rapidly strengthening economy. Goldman Sachs just projected growth in GDP of 6.4% for 2021. If so, this is not necessarily good news for stock prices. It is not unusual for the stock market to discount all the possible good news early leading to a correction (of whatever duration and depth) when interest rates start to go up in response to the expectation of higher economic growth leading to higher inflation.

The first page of this memo shows our usual three views of stock market performance. The S&P 500 is considered the broadest measure of corporate worth as measured by the total value of the stocks in its list. As technology and social media stocks have gone up rapidly in price, those two categories have had the greatest influence on the direction of the "market" today. Technology alone (most social media stocks now reside in the Communications category) now represents almost 30% of the entire stock market's value. If technology does well, so will the S&P.

The Dividend Aristocrats Index is made up of stocks that have increased their dividends each year for a minimum of 25 years. Thus, it is populated by stocks that have shown great resiliency over long periods of time. It contains only one quasi technology stock. Is that a message for the future success and resiliency of today's highflyers? No technology is the reason the Aristocrats lagged the S&P so much last year. But over long periods of time it has pretty much matched the S&P due to the defensive nature of many of its holdings. Unlike the S&P, the stocks in this index are equal weighted. While none does it really well, this is the index that most closely represents our approach to investing – high quality stocks that pay a dividend.

The Russell 1000 Value represents, for the most part, the lower valuation and out of favor segments of the market. This is where most of the raw materials stocks (metals, oil, chemicals, timber, etc.) reside and it is characterized by low price earnings ratios within many highly cyclical sectors of the stock market. These companies need higher inflation to gain pricing power and earnings growth. Most banks, that traditionally sell at lower valuations than industrials, also fall in this category as they wait for higher interest rates to improve profits and lift valuations.

With these definitions in mind, we can see that the fourth quarter represented an apparent change in preferences on the part of investors. While most stocks went up, the value stocks in aggregate, led the way, at least as measured by the Russell 1000 Value Index. This has not happened for a number of years and is a clear signal that the market (right or wrong) expects inflation and a better economy to come. This has continued into this year as some of last year's worst performers (those in the value sectors mentioned above) turned around and made major advances. Dow Chemical for instance is up 20% over the past three months while Microsoft and Amazon (two performance heroes for many years) have been flat.

Feeding both potential inflation and the stock market has been the dramatic increase in money by the Federal Reserve Bank, continuously since the financial crisis of 2008-2009. This past year, however, represented a huge increase from previous periods. By some measures, the money supply increased at an annualized rate of over 19% in the fourth quarter. Growth in money is what funded the multi **trillion** (yes, **trillion**) dollar stimulus packages. But the real economy does not absorb all of these funds immediately. At least temporarily, they end up in the financial markets. This is what forced interest rates down and the stock market up to extraordinarily high valuations with a large portion of this being concentrated in the "new" technologies. To the extent this process slows this year and this money is absorbed by the real economy, we should expect some reversal of this process with concomitant declines in some of these stocks, even as they continue to do well fundamentally. The much publicized historically high valuations will begin to gravitate back toward more normal levels. At year end the high flying FANGMA stocks (the original FANG stocks - Facebook, Amazon, Netflix and Google – now plus

Microsoft and Apple) sold at an average 60 times trailing earnings, a level even the best companies were unable to sustain in past market declines. As we have said before, although not always evident, risk is always present and at the moment it is high.

As we write this letter, the best performing sectors over the past three months have been Basic Materials, Finance and Energy. All have been at the bottom of the performance list for an extended period of time but over this past quarter, all returned over 20% with Energy the biggest winner returning almost 40% in three months' time. Technology, on the other hand returned less than 10%. Is this the beginning of a new trend or a simple period of catch up for the laggards? We shall see as the year unfolds.

Top 20 Holdings

The end of the year saw no change in our largest holdings from the last quarter. At year end, our list of top twenty stocks was as follows:

3M Company	Illinois Tool Works Inc.
AbbVie Inc.	Intel Corporation
Ameriprise Financial	Lowes Companies Inc.
Amgen Inc.	Microsoft Corporation
Archer Daniels Midland	Pfizer, Inc.
AT&T Inc.	Polaris
Cardinal Health	Qualcomm Inc.
Cisco Systems, Inc.	Starbucks Corporation
Enterprise Products Partners L.P.	Technology Sector SPDR Fund
Fastenal Company	United Parcel Service

The fourth quarter was a terrific quarter for our top holdings and value stocks in general. Looking back at how our top holdings fared, we largely see similar patterns from the sectors driving overall market performance. Energy and Finance led the way, as previous laggards Enterprise Products Partners (Energy) and Ameriprise (Finance) were both up more than 25% for the quarter. Our best performer was semiconductor company Qualcomm, which was up around 30%. While Qualcomm did much better than most of its technology peers (including our other top 20 holdings Microsoft, Intel, and Cisco), its run up was not a great surprise to us. Qualcomm is the largest maker of mobile phone chips, and it is well positioned to gain from the rollout of 5G. Because of its patented technologies, Qualcomm earns a royalty for nearly every mobile phone made, whether the phone includes a chip made by Qualcomm or not. While the stock was our best performer for the quarter as well as for the year, we anticipate holding on to the stock for some time to come as our window on 5G.

Rounding out our top performers were Starbucks and Abbvie, up 25% and 24% respectively. Starbucks staged an incredible turnaround for a retailer despite the remaining headwinds of Covid, and the company is now trading above its previous highs. Meanwhile Abbvie was a bright spot among our healthcare stocks, easily outperforming the healthcare sector after a somewhat controversial acquisition of Allergan earlier in the year. Abbvie is one of the few stocks we hold that has performed extremely well yet still appears "cheap" by many of our metrics.

On the other side of the equation, our laggards for the quarter included Amgen, Intel, Lowes, Pfizer and Polaris, with the first three in slightly negative territory and the last two slightly positive. Aside from Intel there does not appear to be any great explanation regarding why these companies' stocks lagged over the last quarter.

Intel has been a successful holding for us over the long term, but it has disappointed more recently as investors have become concerned that the once dominant maker of computer processors is losing its edge. For instance, Apple has announced that it will begin producing its own chips in a few years and Microsoft whose operating systems grew up on Intel, has hinted it may do the same. Intel's strength has always been the size of its research budget but when cash flow giants get into the business, that may no longer be the case. This has sparked the interest of activist investors who hope to make some changes to the company (and has helped the stock bounce back a bit from its December low). We have already trimmed back Intel in accounts where it is large, and the stock remains on our watch list for the time being as a potential sell.

Pfizer had a big bump in late November / early December as its Covid vaccine was the first to be approved both in the U.K. as well as the U.S., but it has since given up most of those gains for no particular reason that we can see aside from general lackluster performance among healthcare stocks.

The same is true of Amgen, now a member of the Dow Industrials. This biotech company is the largest in its industry, sells at a valuation well below the general market and is expected to show strong growth in dividends and earnings over the next several years. There are no questions here in spite of poor recent stock performance.

While Lowe's was a laggard last quarter it did very well for the year as a whole, up about 30%. And, in spite of a strong year, it still looks cheap, if not very undervalued by at least some of our measures. The only negative here is that the strong appreciation in the stock price has reduced its attraction for some dividend investors.

It is not surprising that Polaris had a tough year, at least in terms of perception. Recreational vehicles don't jump to the front of anyone's mind during a year of shutdowns. But in spite of this, earnings are expected to have grown last year and the same is anticipated for 2021. It is also likely to become a Dividend Aristocrat at the beginning of next year. That a company in as cyclical a business as theirs (all-terrain vehicles, snowmobiles and motorcycles) has been able to grow its dividend for twenty-five years in a row is a tribute to management. They have been a substantial generator of excess cash for many years and this is one of the quality measures we look for in making our selections.

With the possible exception of Intel, we like all of these companies for the year ahead. For many of them last year, their only issue was that they were neither technology nor social media companies, as that is what dominated market performance.

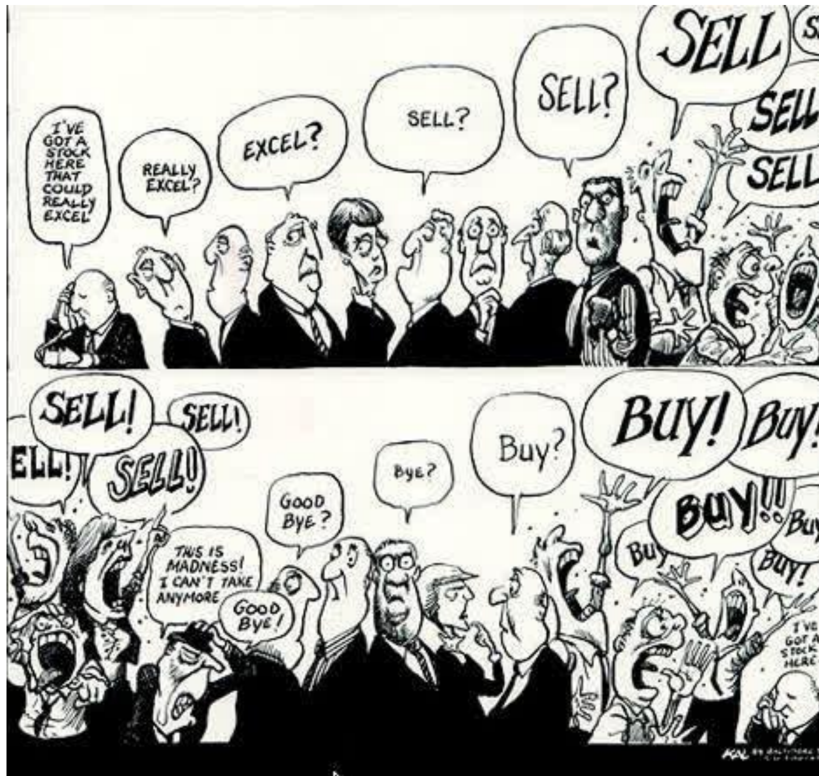
Implications from the Elections

The vast majority of presidential election years have produced positive returns so maybe we shouldn't be surprised that stocks did well last year. In addition, interest rates declined from already very low levels leaving few liquid alternatives to common stocks, though dividend stocks in general still lagged the overall market.

But a new beginning will start after Inauguration day with respect to many policies enacted over the past four years. Some will work well and some will not. Both higher taxes and reregulation (however appropriate and necessary) reduces the disposable income of individuals and leaves corporations with less cash to reinvest for future growth. Foreign policy direction is a major open question.

How the market will react to all of this is simply not known. And what the Senate will pass is also not known as a few members from both sides have already stated what they will not vote for. With Congress almost evenly divided, most policies are still up in the air. One thing is for sure – the financial markets don't like unknowns and there are bound to be some unwanted surprises as well. Saber rattling has already been started by North Korea and Iran.

The More Things Change …



Above is a cartoon that a friend of Doug's first passed along to him over thirty years ago. For a long time, it was lost. Yet, the other day, in reading a recent article on market cycles there it was again. Over long periods of time some things never change and this was especially illustrated by the volatility in

some sectors of the stock market last year. Yet many people are acting as though we are still at the beginning of the upward cycle. Only time will tell.

Final Thoughts

As a former director of a mutual fund he managed once told Doug when the market was high, “it may be time to put a little hay in the barn”. This is especially true for those clients who will need cash over the course of 2021. If there is any planned change in withdrawals, just let us know so we can be sure to plan ahead and sell while we know the market is up.   If there are any questions on specific strategy for a particular portfolio over the course of 2021, please give us a call.

Finally, but certainly not last, we are pleased to announce that Emily Sands was named President of the company as of December 31. This does not imply any major change in internal responsibilities at this time but is in recognition of the many responsibilities she has assumed since joining us fifteen years ago.

Sincerely,

Loudon Investment Management, LLC

DML/ELS/JJS/LO