RIVERWATER PARTNERS LLC

July 24, 2017

Dear Friends,

We, as stock investors, have been spoiled as markets continue to go up with virtually no downside. The VIX, or CBOE Volatility Index, has been trading at its lowest level in 25 years. How long can this investment environment exist?

In the first half of 2017, 26 of the 30 major global indexes were up. Not since 2009, and only four times in the last twenty years, have gains been this widespread. What do these worldwide gains foretell? Not much. The four times in the last 20 years this many indexes were up, the world saw continued gains twice and twice experienced a correction. We, along with many in the industry, consider the odds for a market correction to be higher than this 50%.

In fact, history indicates a correction may be overdue. We are now in the second longest running bull market ever. Over the past 50 years, stocks underperformed when rates rose and earnings growth slowed. Valuations are at the high end of historical ranges, earnings growth is likely to soften going forward and the Federal Reserve is raising interest rates.

Looking strictly at statistical frequency of corrections, the market is due for one. The market has had only four 10% corrections since the financial crisis. This is striking because during the 110-year period between 1900 and 2010 the stock market averaged one 10% correction per year. The last time we had just a 5% correction was over 9 months ago, where markets typically average 4 every year. Further, the markets have not experienced any 20% corrections since 2009, but based on historical averages should have self-corrected at least twice.

You may recall that we were equally bearish last year. Notwithstanding, we managed to outperform in a strong market environment. We are pleased to report that we beat the benchmarks in our Large Equity Income and SMID (Small and Mid) portfolios during both the past quarter and year-to-date. By running a focused portfolio of stocks, we have managed to find great companies that were and still are mispriced, all while trying to maintain a defensive position.

We are now entering the worst season for investors. The saying “sell in May and go away” actually does have statistical backing as most corrections happen in the August, September, October timeframe. Whenever the market takes a leg down, our advice to you is do not fret over your account values. It is never fun to watch accounts go down, but as evidenced by the market’s history going back over the last 110 plus years, downswings are NORMAL. We actually look forward to one so we can buy stocks on our watchlists that today are not cheap enough.

The average investor today owns a stock for less than a year! This is crazy to us because there is little to no correlation between a company’s earnings and stock price over such a short time period. Robert Hagstrom wrote a book called *The Warren Buffet Way* in which he ran a study to discover how much earnings impacted stock prices over different time periods. Hagstrom found that over multiple three-year holding periods, the correlation between earnings and stock price was only about 27%.[1] If you expand the time frame to five years the correlation jumps to between 37% and 60%. For 7-year data it grows to between 47% and 67%. You can see that it takes a long time for earnings alone to have an actual impact on stock prices. This is why whenever we make a buy or sell decision it is in the mindset of a business owner, not a trader.[2] We consider a company’s prospects years out into the future when making every decision.

[1] Correlation: in the finance and investment industries, is a statistic that measures the degree to which two securities move in relation to each other.

[2] Two other material benefits to having a long-term view is reduced trading costs and lower taxes.

We did not add any new positions in the Large Cap strategy for the second straight quarter. We still like everything we own and thus did not sell anything during the second quarter. We've calculated our turnover at below 10% since inception in our Large strategy; at the current rate this means we would hold on to our names for more than 10 years.

We've been noodling a couple of ideas in the Large portfolio. If markets cooperate, we should be able to find a new name or two before our next letter. Our best performing stock year-to-date is Royal Caribbean, up over 35%, and our worst is Chevron, down about 9%.

Royal is one of the largest cruise lines in the world with 49 ships and over 123,000 berths. It has the most fuel-efficient fleet in industry and is a 2017 Ethisphere honoree.[3]

Royal had a nice quarter beating Wall Street's earnings guess and raising their outlook for the rest of the year. They are now predicting double-digit earnings growth for the fifth consecutive year. Oil is a fairly large input cost and its recent swoon should help them.

In contrast, oil has tempered Chevron's outlook and for that matter the entire energy complex. The Energy sector is the worst performing year-to-date and actually has had the worst relative performance versus the rest of the stock market going back 17 years. We are underweight the sector in large and have no exposure in small.

Chevron is close to completing two large natural gas fields in Australia which will cut down on their costs and boost their cash flows. Energy production should grow at a high single-digit pace next year and the stock currently has a 4.2% dividend yield. Chevron has consistently ranked at the top of its peer group on both a safety and environmental basis. In 2016, they achieved a score of 100 percent on the Human Rights Campaign Corporate Equality Index for the 12th consecutive year.

Our SMID portfolio, driven by nice gains in a number of names over the past six months, also outperformed with Agrofresh up over 200%, and FMC, Grand Canyon and Oaktree all up over 30%.

We were a bit more active in this strategy having sold two holdings due to poor future outlooks – Rite Aid and United Natural Foods. Rite Aid was our first mistake. We thought the merger with Walgreens made sense and would be approved based on the company satisfying the government's requests. This was not the case.

United Natural Foods is a distributor and does well when there is food inflation of which there none now. We got lucky because after we sold, Amazon announced a merger with Whole Foods. Whole Foods was and still is United Natural's largest customer. It has been a long-standing relationship and it's now potentially in limbo with Amazon running the show.

Our timing on the sales were good as United Foods is down over 10% since we sold and Rite Aid is down more than 35% from when we sold a majority of our position.

We also trimmed our FMC corporation position as it rallied strongly on the swap of its Health business for one of DuPont's segments. We felt the position size was larger than our conviction in the upside potential. We still like it, but are more comfortable with an average size weighting vs. above average.

We also made two new purchases in the quarter – Jones Lang LaSalle and Interface. Both are tied to the commercial real estate market, are undervalued, and are leaders in environmental sustainability.

Jones Lang LaSalle (JLL) is a leading global real estate services company headquartered in the United States. We were attracted to the stock after it experienced a post-BREXIT correction and shifted its business model from transactional to 60% fee-based. We believe this will create a more stable revenue stream and allow the firm to better weather downturns.

[3] Ethisphere Institute has honored companies who recognize their role in society to influence and drive positive change in the business community and societies around the world.

Jones Lang LaSalle, like Royal Caribbean, has been recognized as one of the "World's Most Ethical Companies" by the Ethisphere.

Interface is the world's leader in carpet tiles and recently expanded their product offering into luxury vinyl tile. It is attractively valued and their new CEO has implemented a plan to cut costs. We believe they are poised to see significant margin expansion. As socially responsible investors, Interface was also attractive because of its commitment to the environment; it has a goal of a net zero environmental impact by 2020.

I had the opportunity to tour some of the manufacturing facilities and design studio in Atlanta last month and was very impressed (if you want to really jazz up your office or home check them out).

We are still finding some great ideas but they remain few and far between. If a correction comes and lowers stock prices, know that it is a great opportunity to buy. Compare it to buying winter jackets in April when they are on sale; not many people think about new ones at that time, but they will wish they had come November. It's also best to buy when the stock market is down. Consider that the S&P 500 has had positive returns over every 15-year rolling time frame since 1973[4]. Buy, don't sell, when the market is on sale!

This phenomenon is illustrated in the chart below. Bull markets last much longer than bear markets even though the experience and memory of bear markets are painful. On a relative basis look at how short the financial crisis was, even though it didn't feel that way.

Source: Wells Fargo Asset Management, *Risk Revision Q2 2017*

We were happy with the attendance during our open house and loved seeing so many of our clients and friends here. If you have not had the chance to swing by our new office, our doors are always open (if not open they are unlocked). We hope to be hosting quarterly events in the new space and look forward to our first, hopefully in September.

[4] Anspach, Dana. "Best and Worst Rolling Index Returns 1973 - 2016." The Balance. N.p., 28 Apr. 2017. Web. 21 July 2017.

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Have a great second half to your summer and please reach out with any questions or burning desires to make contributions to your account, open new ones, or make friendly referrals.

All the best.

Adam | Michael | Laura | Matt