April 26, 2018

Dear Friends,

Q1 RECAP

The first quarter could very well turn out to be a memorable inflection point in this 10-year bull market. The broad indices ended their nine-quarter streak of positive returns, volatility returned with markets moving up or down with much greater magnitude, and the bull market leaders Facebook, Apple, Amazon, Netflix and Google are not looking so bulletproof anymore.

Stocks ran hard in January, then hit some headwinds shortly after the new year in reaction to proposed tariffs, privacy concerns at Facebook, and a Fed tightening cycle that appears to be picking up steam. We cannot handicap how the tariffs will play out but are confident that if they are instituted and other countries respond with reciprocal tariffs, the result will not be positive for equity prices.

We have limited direct exposure to the steel and aluminum tariffs in the portfolio, but believe that the secondary and tertiary effects will be felt across just about every company in America.

We continue to position both portfolios in a more defensive manner. This was evident when looking at our returns vs. our benchmarks. We lagged quite a bit in the January run-up, but gained significant ground the following two months. This movement was especially pronounced on larger down and up days. We protected capital well on big down days but did not fully participate in up days. We ended the quarter essentially in-line in our SMID portfolio and beat in the Large portfolio by a very comfortable margin. Our benchmark for Large is the Russell 1000 Value, which was down 3.5%, and for SMID it is the Russell 2500, which was down 2.0%.

DEFENSIVE INVESTING

We consider ourselves defensive investors with a value bias. Value underperformed this quarter (the Russell 1000 Value was down 3.5% vs. the 1000 Growth up 1.1%), continuing its roughly 10-year run of lagging growth. These Value vs. Growth cycles historically have gone on 7-10 years, making us due for a turn.

You may be asking yourself what is “defensive” investing. This means that we prefer to buy companies that make money, have superior returns on capital, don’t use excessive debt to fund operations, and have stable revenue streams that hold up during bad times. We look at all of these factors and then try to pay a fair price. One would think that most companies make money, but as markets have evolved over the years and more and more emerging companies have gone public in the healthcare and technology space, many of those companies have consistently lost money.

Tesla is a perfect example. Recently, Tesla has become the largest company by market valuation of all US-based car companies. Since going public in 2010, they have not made any money. Notwithstanding, the market believes they eventually will and that it will be enough to support a $51 billion valuation.

Tesla is not alone. In the Russell 2000, the small cap index, close to 25% of companies lose money. This compares to only 13% in 1997 and 17% in 2008 during the financial crisis. The money losers, in our opinion, will underperform the rest of the market in the next recession and we believe the defensive companies we described above will outperform.

RECOGNIZING FAILURE

We were fairly active in both strategies during the quarter but before we get into the details, we want to stress that we always look out over the long term and try to make every investment decision on this basis. We also want to be as open and honest in both our successes and failures so that you can use these updates to properly evaluate us. As a team we recently read and highly recommend *Principles* by Ray Dalio. Dalio runs Bridgewater, the largest hedge fund in the world, and speaks to the upside of failure by noting that, "Intelligent people who embrace their mistakes and weaknesses substantially outperform their peers who have the same abilities but bigger ego barriers."[1] You cannot improve without figuring out what went wrong, why it went wrong and have a plan on how to prevent it from happening again.

As investors, we found one of the most interesting news stories in the quarter to be the decline at General Electric. It appears failures there were either ignored or not given enough regard. This is evident in the title alone of a recent *Wall Street Journal* article "*How Jeffrey Immelt's 'Success Theater' Masked the Rot at GE – A Culture That Disdained Bad News Contributed to Overly Optimistic Forecasts and Botched Strategies*."

GE is the only company in the Dow Jones since its inception. This storied company has had a bad run while the market and its industrial peers have shined. GE is down over 50% since the beginning of 2017 while industrial peers in aggregate are up double digits. We do not own GE, nor have we in the past, but we believe their culture of over-optimism was a contributing factor to their current downfall. "The history of GE is to selectively only provide positive information," said Deutsche Bank analyst John Inch. "There is a credibility gap between what they say and the reality of what is to come."[2]

At Riverwater, we strive to invest in companies that tell it like it is and we strive to do the same for you. We will always fill you in on our mistakes and have no intention to ignore or obfuscate investments that don't go well. While this doesn't make for a great marketing piece, we believe that knowing all the facts makes our letter more useful. A study done by Rittenhouse found that candor plays an important role in corporate success; companies that were the most candid both in their words and numbers had superior performance.[3] You can check out the link in the footnotes, but the most candid trounced the market over a ten-year timeframe ending in 2016.

Given that some of you only own one of our two strategies we've decided to break the two out separately to save you time should you not want to read about investments you do not own. We'll discuss significant trades and any pertinent portfolio positioning. If you are already bored, this is a good place to stop.

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[1] Dalio, Ray. *Principles*. Simon & Schuster, 2017. Pg. 351

[2] Gryta, Thomas, et al. "How Jeffrey Immelt's 'Success Theater' Masked the Rot at GE." *The Wall Street Journal*, Dow Jones & Company, 21 Feb. 2018, www.wsj.com/articles/how-jeffrey-immelts-success-theater-masked-the-rot-at-ge-1519231067.

[3] http://www.rittenhouserankings.com/wp-content/uploads/2016/12/2015-Rittenhouse-Rankings-Candor-AnalyticsTM-Survey-Report.pdf

LARGE EQUITY INCOME PORTFOLIO

We sold two positions in the quarter, Boeing and NXP Semiconductors, both at nice gains.

Boeing was our best performer last year and returned a whopping 85%. We trimmed the position last year and exited entirely this quarter based on extended valuation. The fundamentals are very sound for the company as it has a backlog of sales stretching out to the mid 2020's. Its valuation, however, stretched farther than it had ever been. Below is a chart of its Price to Sales since 2002. Remember the axiom *buy low sell high*. Boeing is currently trading at a valuation level for sales that it has never seen. While it is possible that the valuation paradigm has changed and the stock deserves to trade this rich, we doubt it.

The center line is the average and the outside lines represent one standard deviation from the mean.

We also sold **NXP Semiconductors**. They focus on providing chips for the auto industry. Every year as cars get smarter they require more computing power. Today the average car has more computing power than the system that sent the Apollo astronauts to the moon.[4] Qualcomm offered to buy the entire company for $110 per share, but investors thought it was not enough and the stock eventually traded up to around $120 per share. We felt like the risk/reward was balanced in what the upside vs. downside case could be and exited the position. Post our exit, Qualcomm did raise the buyout price to $127.50. While we potentially left some chips on the table, the stock is still below where we sold as the deal is now being held up by China because of the trade dispute with the US.

We bought **Newell Rubbermaid** after it dropped in half from its high in 2017. The company has too many well-known brands to list, but some are Elmer's Glue, Coleman, Graco, Sharpie, Yankee Candle, Oster, Crock Pot and of course Newell and Rubbermaid. Newell merged with Rubbermaid and then with Jarden to create a consumer behemoth, but the cost savings and execution have

[4] *Your Car Has More Computing Power than the System That Guided Apollo Astronauts to the Moon | Posters*, www.physics.org/facts/apollo-really.asp

not lived up to the hype. You will notice it is trading BELOW its historical Price to Sales trading multiple unlike Boeing.

The center line is the average and the outside lines represent one standard deviation from the mean.

There is a proxy battle that appears to have been won by Carl Icahn (a billionaire corporate raider), but another activist group is trying to gain board seats at the upcoming annual meeting. We are attracted to the breadth of brands, the opportunity to increase their margins A LOT, and a very cheap valuation. It trades for around 10x earnings and produces prodigious free cash flows. They have more debt than we'd prefer but we like that they have made it a priority to sell non-core brands and use the proceeds to pay off debt.

We also bought **CenturyLink**, an undervalued and misunderstood stock in the Telecommunications industry. CenturyLink is lumped together with other old telephone companies like Cincinnati Bell and Windstream. Those companies have cut their dividends, loaded up on debt, and doubled down on old businesses. CenturyLink, in contrast, has made a transformative purchase of Level 3 Communications, a leading provider of broadband. This purchase has diversified its business away from old rural copper wireline to more high-speed fiber business. It is currently the second largest broadband carrier to businesses behind AT&T and is now larger than Verizon.

CenturyLink has a high dividend yield of about 12%, which the market does not think is sustainable. Management has repeatedly committed to the dividend and paying down debt. The focus is now on growing cash flow through roughly $1 billion in synergies and increasing revenues by moving customers from low margin products to higher margin high-speed broadband products. This will move CenturyLink's dividend payout closer to 70%, which is in-line with AT&T and Verizon.

If CenturyLink trades at a FCF multiple similar to AT&T and Verizon, we believe the stock should be in the high $20s vs. the high teens today.

SMID PORTFOLIO

We were more active than what we would have expected in a normal quarter. The activity was driven by success of two of our larger sized companies, **Corning and M&T Bank**. Both stocks crossed past our $20 billion market cap range and we felt it necessary to recycle the proceeds into smaller companies.

We also sold **Manchester United**. We liked Newell so much we bought it in this portfolio as well and needed to cut back in the consumer discretionary space to make room. Manchester United has a great brand as the number one sporting franchise on the planet with hundreds of millions of fans. We can see much more upside in Newell though, and were content selling.

Our big mistake in the quarter was **Macquarie Infrastructure.** They operate in four unique business segments: bulk liquid terminals, small private airports for jets, solar/wind power and they own the only Gas Utility in Hawaii. Each of these segments maintain high barriers to entry and multi-year revenue contracts. The company was negatively impacted by the decline in an oil grade that is being phased out in their tank terminal segment. This caused capacity utilization to decline and requires investment to retrofit the storage terminals for new products. It also caused the stock to tank!

Given the investment to retrofit and desire to maintain an investment grade debt rating, the new management team cut the dividend after the company had previously indicated on the prior quarter conference call that the dividend was safe. The unexpected cut sent shockwaves through the investor base. This lead to what we believe was a loss of credibility in new management and an overreaction in the stock. The parent company Macquarie Group has announced intentions to acquire additional shares of the company to add to its 6.6% ownership. Additionally, an activist investor has called for a strategic review or sale of the company.

The announcement gives us confidence that the current stock price does not reflect fair value. We doubled down on our position as it was down 40%. It now trades at a more than 30% discount to its average valuation since going public on cash flow and sports a 10.5% dividend yield (after the cut), which is supported by prodigious free cash flow.

We initiated a new position in **Alpha and Omega Semiconductor**, a designer, developer and manufacturer of power semiconductor products which is expanding about 6% annually, driven by the growth of electrically-powered products and the spread of electronic content into more products.

Alpha historically sold its products into the PC market, which has experienced declining growth over the past few years. Alpha has kept its business flat in this segment though and wisely recognized the need to diversify into other end markets; Consumer (appliances, gaming, and TV), Communications (smart phones, networking), and Industrial (lighting, motion control).

They recently entered into a joint venture in China for manufacturing, which will increase capacity by 50%. This will drive cost savings and enable the company to meet increasing demand. In addition, Alpha has signed an agreement with ST Microelectronics, another semiconductor company, to make leading edge semiconductors for the server market, which is experiencing significant growth as all things move to the Cloud.

We think Alpha has an opportunity to grow its top and bottom line, which can drive earnings power of $0.70 in 2018 and $0.85 in 2019, up from $0.57 in 2017. Trading at $15.50, with $7.50 per share in cash and virtually no debt, we believe there is significant upside to the stock price.

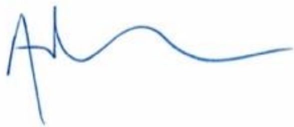
We also bought **Perrigo Company plc**, a leading global healthcare company, which manufactures over-the-counter private label products (think cough, cold and allergy) for sale in the US & Europe as well as generic prescription pharmaceuticals. Perrigo's stock price declined substantially during 2016-17 as generic drug makers experienced significant stock price erosion fueled by the competitive nature of the generics business. Perrigo is somewhat insulated from this pricing pressure given the proprietary nature of its topical technology used in generics.

Perrigo has consolidated its distribution of private label drugs in international markets, which will drive operating margin growth over the next several years. In the US, Perrigo will benefit from continued switching to cheaper, but equally effective private label brands from the more expensive branded products. Retailers like it too because they earn more money selling private label than branded. In addition, Perrigo manufactures Amazon.com's GoodSense brand, which we believe will have significant growth as Amazon continues to take market share.

With high-single digit earnings growth over the next several years, a strong balance sheet, and trading at a discount to the market, we see upside to Perrigo's share price.

We appreciate your trust and confidence in us and please reach out should you have any questions or know of anyone that you think would have an interest in our services.

All the best.



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