RIVERWATER PARTNERS LLC
INVESTING BESIDE YOU®

October 12, 2017

Dear Friends,

Another quarter in the books and another quarter where equity markets had broad-based gains. Our benchmarks, the Russell 2500 and Russell 1000 Value, were up 4.7% and 3.1% respectively, while every sector in the S&P 500 was up except for Consumer Staples. Our large strategy outperformed its benchmark, while our SMID strategy trailed. Both are still outperforming over the last 12 months - we now have one year of performance for both strategies!

It is amazing to reflect on the changes across the globe since we started last year; BREXIT, Trump, Macron in France winning the national election, a devastating hurricane season and maybe the most terrifying of all, North Korea launching missiles over Japan.

A not so well known Greek philosopher named Heraclitus once said, “the only thing that is constant is change.” Change is both the greatest ally and greatest foe to investors. As investors, we often desire change when a company’s fortunes are bleak – if things are bad, something must change for it to get better. In this respect change is good; whether it be in the form of an industry shift or something internal that drives operations in a positive direction.

Conversely, change is bad when the market and competitive dynamics are in a company’s favor. Think about newspapers. Until the turn of the century, most local papers had virtual monopolies in their respective geographical footprints. They would be the go-to place to sell your car or post a job opening. With the advent of the Internet, everything changed and newspapers’ fortunes dwindled. As investors we are always looking for positive change while at the same time trying to avoid companies subject to negative change.

Speaking of change, we sold two companies in our SMID portfolio this past quarter. This hurricane season was one of the worst in history and the devastation across Houston, the Florida Keys, and Puerto Rico was truly catastrophic. We owned a company called Evertec which is a leading credit card transaction processing company in the Caribbean. With the vast majority of their business in Puerto Rico it will be a long time until business gets back to normal. We still like the company and the long-term outlook, however it is very difficult to handicap how long getting to normal will take so we decided to sit on the sidelines for now.

We also sold USG Corporation, a company for which we did not initially take a full portfolio position. With the pricing dynamics in the industry not living up to our expectations we decided to exit much earlier than we would have liked instead of continuing with a half-baked idea.

We did not initiate any new positions in the portfolio but keep digging for great ideas and have found two ideas worthy of addition and expect at least one will end up in the portfolio before year-end.

The markets continue to hit all-time highs as I write this letter and small caps have just had a nice surge on Trump’s most recent tax plan lowering corporate tax rates to 20% from 35%. Large companies have much lower tax rates than smaller ones and so whenever talk of lower taxes erupts small companies will typically outperform. We clearly saw this as the small company index was up 3.8% since the plan was announced vs. 1.3% for large companies.[1]

We did add to our position in Smucker's in both the SMID and Large portfolios. It sold off on their last quarterly earnings report after they disappointed on sales and earnings growth. We think it will take time to turn around a number of their brands, but we are confident they will. We are attracted to its Price to Earnings ratio of 13.6 and the 3% dividend yield doesn't hurt. They have actually raised the dividend for the last 19 years in a row.

We love companies where if we were to take a 10-year vacation to a nice island we would be fairly confident the company would still be around. An interesting stat for all new startups is that only about 30% are still around after the first ten years.[2] Public companies have a much better success rate, but even in a stable economy, 99 public companies representing over $100 billion in pre-petition assets filed for bankruptcy last year.[3]

We are 99% confident that consumers will still be eating PB&J in late 2027. We are also very confident they will still be buying JIF and Smucker's jellies. So yes, sales are slow, but it is very difficult to kill a world class brand and Smucker's has dozens of them: Crisco, Pillsbury, Folgers, Meow Mix and Milk Bone are just a handful.

We sold out of one position in our Large strategy, Johnson Controls. The hardest decision is always when to sell and this one was no different. What attracted us to the stock were the opportunities created when Johnson Controls combined with Tyco. Tyco, best known for their fire and security alarms, was a natural complement to Johnson Controls' Heating and Cooling business. The merger offered a more comprehensive and innovative building technology product portfolio to a salesperson calling on a commercial building. Additionally, the merger mapped out $1B in cost savings by eliminating duplicative assets. Unfortunately, the merger synergies are proceeding slower than planned and we did not see enough positive momentum to keep holding. In addition, we were losing confidence in management's ability to integrate and grow the businesses in the near term.

We did make a new purchase in the Large strategy and bought CVS HEALTH Corp. CVS is a leading pharmacy innovation company. We liked the valuation; it has a 2.4% dividend yield, a 7.8% free cash flow yield and trades at 13.7x this year's earnings vs. the market at 19.3x. The stock has floundered for the last two years. They lost a couple of large contracts, generic drug pricing has been negative and there is a fear Amazon will enter the pharmacy business. CVS sold off the day Amazon announced the Whole Foods deal. We think these are the reasons it is so cheap. The biggest seems to be Amazon and we believe an entry into the space is unlikely in the near-term. Amazon began talking publicly about grocery stores 10 years ago and started doing grocery tests in Seattle six years ago. So far there has been no public talk of investing in the space and no sign of major job postings, although they did hire a business lead this past May. We think the deeply discounted valuation is appropriate for the headwinds and actually think they could surprise the market to the upside in the coming years.

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[1] Russell 2000 for Small and S&P500 for Large. The performance is for the four trading days following the tax plan announcement on September 26th.

[2] Bureau of Labor Statistics https://www.bls.gov/bdm/us_age_naics_00_table7.txt

[3] https://seekingalpha.com/article/4035631-2016-corporate-bankruptcy-recap-bankruptcies-25-percent-41-percent-oil-and-gas-energy-sector

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Towards the end of the quarter, I attended an investment conference sponsored by a large institutional consultant in Chicago. They do a great job of bringing in interesting keynote speakers. Last year it was *Freakanomics* author Steven Levitt. His message was don't be afraid to quit. (See last year's 3rd quarter letter for details). This year the keynote address was from Adam Braun, founder of Pencils of Promise. Braun founded the organization to build schools in underdeveloped countries where over 250 million children do not know how to read. So far, they have built over 400 schools and educated over 74,000 students in 2016 alone.

His story was also about change and it was impressive. To highlight the infinite power of small changes, Braun showed how individual dominoes can knock over a successive domino that is 1.5x larger than itself. Starting with a domino that is only 5 millimeters high by 1 millimeter thick, that domino can knock over the 13th domino which is about 100 pounds. If you go out to 29 dominos, the first domino would be able to knock over the largest which would be as tall as the Empire State building![4]

Like the dominos, incremental changes can produce significant results to a company and its stock performance. Our focus is on identifying companies in the midst of positive change or those where negative changes are unlikely over the long-term. We are confident in our portfolio positioning even with the expectation of continual, and often unexpected, changes in world events.

Finally, we are excited to announce an addition to our research team! Cindy Bohlen has joined Riverwater Partners as an analyst. Cindy has the Chartered Financial Analyst designation and previously worked as an analyst and portfolio manager at both Robert W. Baird and M&I Investment Management Corp. Cindy is also our Chief Mindfulness Officer (CMO). In that capacity, she builds on her experience working for a socially responsible investment firm and private foundation and will lead our efforts in socially responsible research.

Have a great fall, enjoy the color change and please reach out to us with any questions.

All the best.

Adam Cindy Laura Matt

[4] You can watch the video at https://www.youtube.com/watch?v=5JCm5FY-dEY