RIVERWATER PARTNERS LLC
INVESTING BESIDE YOU®

January 16, 2017

Dear Friends,

It doesn't get much better than this! Double digit gains across major stock indices, twelve straight months where the S&P 500 never went down (first time in its history), and record low volatility. The economy is finally out of second gear with GDP at +3%, unemployment levels at 18-year lows, consumer confidence at levels not seen since 2004, and tax rates heading lower.

It is not certain how long this run will last. Since the S&P 500 inception in 1927, there have only been three streaks longer than the current 300-day run where the market did not drop 5% and the next record to eclipse is 326 days, set in 1955. What is certain is that the streak will not continue indefinitely.

Using history as our guide, we actually expect the bull market to continue in 2018, but think an intra-year decline is likely. Since 1927, the market experienced 5% average gains in years immediately following those with a +15% return (and annual 15% returns occur roughly 30% of the time). Each of those years following such returns, the market has also experienced an intra-year correction averaging 16%.

We would view a garden variety correction as healthy. The market has averaged one +10% correction every year between 1900 and 2010, but corrections have been significantly less common since the Federal Reserve instituted quantitative easing. The Fed has started the tightening cycle and most prognosticators believe it will continue raising interest rates at least three more times through 2018. [1] Given the time since the last correction, coupled with the Fed tightening, we think the likelihood of a pull-back is high.

Everything is Relative

As we write this, the temperature outside is 23 degrees, but it feels downright balmy after the arctic blast we experienced at the beginning of the year. Like the weather, measuring performance is also relative. While the markets had a great 2017, value investors' returns, which were above the long-term markets' historical average, did not match the returns of the growth camp. The Russell 1000 Value (like the S&P500, but with 500 more companies) had a return of 13.7%. This is an impressive return but not when compared to that of the Russell 1000 Growth, which was up 30.2%.

A 30% gain sounds great relative to 13.7%, but it's peanuts compared to a plus 1,000% gain. That gain belongs to Bitcoin, which became mainstream in 2017. [2] My definition of mainstream is not that the talking heads on CNBC cover it seemingly all day long, but rather when my 11-year old asks to buy it – having never asked to buy any other financial asset, aside from Pokémon cards. A 1,000% gain in a year is quite

[1] https://www.wsj.com/articles/fed-raises-interest-rates-sees-continued-path-of-increases-in-2018-1513191780?mg=prod/accounts-wsj

[2] Electricity usage from bitcoin mining is now more than the entire country of Ireland, every country in Central America and just about every African nation.

rare and feels like a bubble, but it really doesn't hold water to the 36,018% gain in Ripple, one of the other 1,300 plus cryptocurrencies now available.[3]

I do not own any cryptocurrencies and when asked if I would buy them my response is no. The problem is that I personally do not have the toolkit to value them. Should bitcoin be worth $15,000, $40,000, $400,000 or $40? Unlike a business that has sales, generates cash and provides services or goods that people desire, cryptocurrencies are just an alternative (albeit sexier) currency that will only go up if someone is willing to pay more than the next buyer. We prefer companies whose value we can derive from the cash flows they generate.

On a relative basis, we had a respectable showing in both strategies as we beat our respective value indices for the year. Our biggest mistake of the year was that we were positioned too defensively in our portfolios, running them with slightly higher than ideal cash levels.

With that in mind, we'll delve into more of what we got wrong, which thankfully was not as significant as what we got right. We sold five positions in Riverwater's Large strategy at losses that averaged about 15% – AT&T, Gilead, Johnson Controls, McKesson and Walgreens. (since we sold, these stocks as a whole have continued to underperform- with three of the stocks actually declining) The only stock that we held the entire year that declined was First Energy, but it was only down about 1%.

We are happy to report that we owned a lot more stocks that went up than down. While we did not own the market darlings like Apple, Facebook and Amazon, we did own the best performing stock in the Dow Jones Industrial Average, Boeing, which was up 89%. This was followed by TE Connectivity up 38% and American Express up 34%.

In Riverwater's SMID (small and mid-sized companies) portfolio, our top three losers were Rite Aid, USG Corp, and Evertec. The worst performer by far was Rite Aid. We sold it at about a 50% loss. I referenced our blunder here in the second quarter letter. The only solace I can find is that the decision to sell was a good one as the stock has declined 41% since we sold. USG and Evertec lost about 20% and 16% respectively from Jan 1 until the dates we sold. Both stocks are in completely different businesses, but reacted to the same driver; USG makes wallboard and Evertec is a transaction processing company. USG was a mistake because we sold it right before the hurricane season which boosted demand for their product, and hence the stock. Evertec has the vast majority of its business in Puerto Rico and without electricity there, their business has been severely hampered. Since we sold Evertec it is down an additional 12%.

Thankfully, our largest winner in the SMID strategy made up for all the losers as Agrofresh was up 176%. It was followed by FMC Corp which gained 69% and Polaris Industries up a respectable 57%.

We bought two new companies in the fourth quarter for the SMID portfolio: Abraxas Petroleum and ShotSpotter. Abraxas was our first purchase of an energy company in the SMID. We are biased against small cap energy companies as they have a history of destroying invested capital (they focus too much on unprofitable growth) and do not have a track record of disclosing how their operations impact the environment and the communities they operate in.

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3 https://blockexplorer.com/news/top-5-best-performing-cryptocurrencies-of-2017/

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Abraxas does not have good disclosures and had unprofitable growth for a long time. So why invest? First and foremost, founder and CEO Bob Watson is now committed to growing the business within the cash flow that the company generates. Secondly, we have had discussions with Mr. Watson on how the company should begin reporting on its environmental and community impact and try to actively lower its environmental impact. We also think the company was significantly undervalued as it has substantial land holdings in West Texas that were similar to recently sold acreage priced at a 100% premium to where the market values Abraxas today. Since we bought in December the stock has already gained 15%, so maybe the market is catching on.

ShotSpotter is a patented gunshot detection technology utilized across 90 municipalities including in 11 of the 25 largest cities. Milwaukee was one of the early adopters of this technology which addresses a difficult issue most recently highlighted by the Las Vegas shooting. ShotSpotter alerts officers to a gunshot location within a 30-yard radius in 30-45 seconds, thus providing invaluable information prior to the arrival of a crime or assistance in recovering evidence. We were attracted to the name because the market has not fully valued them as a SaaS (Software as a Service) company given their renewal rates are consistently greater than 95%. ShotSpotter trades at a significant discount compared to other SaaS companies and we believe that the valuation will improve as more cities incorporate the technology.

In the Large strategy we were more active and purchased three new names; Tapestry, Maxim Integrated and Nestlé. With the goal of keeping this letter under three pages (is anyone still reading?) we will only detail Tapestry.

Tapestry will not ring a bell for most of you, but we are guessing you would recognize their old name, Coach Inc. Since buying Stuart Weitzman in 2015 and Kate Spade in 2017, the company figured a new name was in order. It has been in a turnaround mode for a couple years, and it appears management is finally getting it done. They cut back on discounting, closed underperforming retail stores and brought fashion back to the brand. It trades at a below market multiple and has a 3% dividend yield. I hope you contribute to their cause in the coming year.

We did not generate any capital gains in either portfolio and kept turnover fairly low at 20% in the SMID portfolio and 12% in the Large. We are keen to generate superior after tax returns and as such will always be cognizant of tax consequences.

We appreciate your trust and confidence in us and wish you a happy and healthy new year.

All the best,

Adam Cindy Laura Matt