July 18, 2018

Dear Friends,

Q2 RECAP

The second quarter equity markets were dominated by headlines surrounding the Trump administration's proposed tariffs. The tariff talk subsequently turned into action with new tariffs enacted by the US, China, Mexico, Canada, the European Union, India and Turkey. The net effect on US GDP is, at worst, estimated to be a .47% drag and would offset 25% of the benefit from the Tax Cuts and Jobs Act.[1] Unfortunately, sentiment and lower corporate earnings can amplify these adverse effects and quickly lead to even graver consequences for markets!

We have already seen the immediate impact across several markets. The dollar rallied with a +5% gain against most major currencies and big export crops for the US like soybeans and corn were down 18% and 10%, respectively. Foreign markets, especially those with big export driven economies, were weak across the board. Close to two-thirds of foreign markets experienced declines during the quarter; the Chinese equity market was off 10%, South Korea was off 9%, Italy down 8%, Germany down 6% and many emerging countries were down double digits, like Brazil which was down 15%.

The US bucked the downward trend and saw gains across just about every equity market. The S&P 500 was up 2.9% versus the Russell 2000 small cap index which was up 7.8%. This noticeable difference between large and small companies is likely based on the percentage of sales that are made outside the US and therefore subject to tariffs.

Small companies have much lower international sales exposure, and therefore less risk, in a full-blown trade war. It is likely because of this size difference that we trailed in our SMID portfolio, where our underweight positioning in smaller capitalization stocks relative to our benchmark, the Russell 2500, caused us to underperform. Year to date, we are outperforming in the Large portfolio and trailing in the SMID portfolio after underperforming this quarter.

WORLD CUP AND ACTION

The second quarter also marked the beginning of the World Cup, the largest and most widely viewed single sporting event. The World Cup, occurring every four years, is a global phenomenon and nice distraction for fans around the world, including traders. Trading volumes on global exchanges where the home team is playing during market hours can see drops of up to 48%. Normally, action, or high-volume trading, is the status quo as most market participants trade way too much.

Action is also the status quo for goalies. Most soccer games are limited to 3 goals or less per team. A large percentage of goals scored occur on corner and penalty kicks. During a penalty kick, the ball is placed 11 meters in front of the goal and because the ball travels over 100 mph, the goalie does not have time to react and must guess where it is going. He can choose to stay put, go left, or go right. On average, goalies only stop 20% of penalty kicks. According to a study

[1] https://taxfoundation.org/tracker-economic-impact-tariffs/

done by scientists who analyzed where shots on goals went, 32.2% went to the left, 39.2% to the right and 28.7% to the center.[2] Based on this, one would think the goalies would also have a balanced distribution. Not so. Goalies went left 49.3%, went right 44.4% and only stayed put 6.3% of the time. This data was taken from 311 penalty kicks.

Why do goalies not stay in the center when it is clear they could increase the amount of goals they stop by staying put, as 29% of shots go to the center, but the goalies only stay still 6% of the time? The study theorizes that inaction (staying in the center and not moving and missing the block) is perceived to be worse than moving and guessing wrong. It looks as if the goalie did not do anything to try and stop the ball when the norm is to move.

Like goalies, action bias is the norm for money management, where the turnover ratios for domestic mutual funds are at 130%, according to William Harding at Morningstar. If a manager does not make any moves and underperforms, he or she theoretically should have been more active. If turnover is 100%, a portfolio would replace every single holding over a 12-month period.

At Riverwater Partners, we try to think like owners and not traders and avoid the impulse to buy into the action bias. Since we started two years ago, we have kept turnover around 10-20%, meaning we are holding stocks at a rate that would keep them in the portfolios for five to ten years. We think that the market often overreacts to good and bad news that is transitory in nature. Though transitory can end up lasting more than a year, this is too long to wait for many investors. That gives us an edge when we can be patient and allow for good ideas to flourish. Sometimes we get lucky, like with **Shotspotter (SSTI)** which is up 196% year-to-date as we pen this letter and sometimes we are too early – **Macquarie (MIC)** is down about 30% since we originally bought. (As we discussed last quarter, we doubled down on the position in the SMID and since then the stock is up about 15%).

LARGE EQUITY INCOME PORTFOLIO

We bought one “new” name in the quarter, **NXP Semiconductors (NXPI)**. You might recall we sold this stock in the first quarter at a nice gain. NXP became a victim of the trade war as China must approve a proposed merger with Qualcomm. We sold very close to $120 last quarter and with the trade rhetoric, the stock dropped back to the low $90s. At that price, we think the stock is very attractively valued with good prospects. We consider this to be a good value even if the proposed deal with Qualcomm does not go through, as NXP is set receive $5 per share if the merger fails. As a reminder, Qualcomm has offered to pay $127.50 per share, which is our estimate of the true value of the company today. Shortly after we bought it, the stock rallied hard to $120 and has since settled at $110.

We trimmed our **Smucker’s (SJM)** position from outsized to slightly below normal weight in both portfolios. The fundamentals of the company have not impressed the market and we decided to cut back to take advantage of the tax loss. It is still attractive over the long-term which is why we still own it and expect over the next three years it will reward us. We also sold **Monsanto (MON)** at a nice gain as the company was bought out by Bayer.

SMID PORTFOLIO

In our SMID portfolio, we bought **Iridium Communications (IRDM)** after meeting with the management team. They are a unique Low-Earth-Orbit satellite company that services the US Government (DoD), emergency responders, and the maritime and aviation industries. Iridium has

[2] https://mpra.ub.uni-muenchen.de/4477/1/MPRA_paper_4477.pdf

spent the last ten years and $3 billion building a state-of-the-art global communications network called Iridium NEXT. It will be up and running by the end of 2018 with 75 total satellites. With no launch costs for the next ten years, free cash flow will jump to over $250 million per year vs. a market value of $1.3B at purchase. We also think sales will inflect higher with new opportunities in maritime and aviation industries.

The new network will allow Iridium to provide maritime and aviation customers with streaming video vs. text and voice. They also will be able to provide commercial aircraft with complete global "radar" coverage, effectively eliminating the loss of aircraft like MH370 that has so far cost over $200 million.

As socially responsible investors, we carefully analyze every company’s environmental and social impact. For Iridium, we were pleased to learn that their new network will be able to save over $750 million in fuel every year because planes can now fly more direct routes safely over water as air traffic controllers now know where they are all the time.

The satellite space is very competitive, but Iridium has an advantage given their spectrum ownership in the L band vs. competition that owns most spectrum in the K bands. With L band ownership in low earth orbit there is no rain or solid object interference. This enables them to be the sole source provider for customers that need 100% of-the-time reliable global coverage.

Also new to the SMID portfolio is **Ciena (CIEN)**, a technology company that provides equipment, software and services for the Telecom industry. It was attractively valued and we think being a leader in the industry will position them well for the evolution from 4G to 5G architectures.

We sold **Allegiant Travel (ALGT),** driven by increased competition (routes with direct competition hit a five-year high), cost increases that are vastly outpacing peers and the risk that the Department of Transportation may initiate an investigation at the request of Sen. Bill Nelson due to safety concerns.

Finally, we also sold **Polaris (PII)**, a leading manufacturer of off-road vehicles and motorcycles. The sale was “driven” by valuation, a $29 million stock sale by the CEO (lowered his stake by 42%) and an acquisition of a pontoon boat manufacturer. On their own, any one of these factors may not have caused us to sell the entire stake but they raised too many red flags when taken as a whole and thus warranted a sale.

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.

Adam Cindy Laura Matt Nathan