RIVERWATERPARTNERS

The Santa Claus Rout
January 4, 2019

The market's year end was both interesting and historically quite rare. Going back to 1950, December has been historically the best performing month, with an average monthly return of 1.53% compared to a 0.50% return for the other 11. The Santa Claus Rally failed to materialize in 2018 with broad markets down across the board and we experienced the worst Christmas Eve in the history of the market. The last time December was this weak was in 1931, making this the worst fourth quarter we can remember.

Why did the market hit an all-time high in October and then fall off the rails? The lack of certainty on the trade war and a flattening yield curve are the leading causes. When long-term interest rates are lower than short-term it signals a recession is on tap in the following 18-24 months. There is no such yield curve inversion yet, but we are very close. While the economic expansion since 2009 is long in the tooth, this decline seems to have priced in an end that is unlikely to come for at least another year.

In December we were also inundated with negative news from Washington including high-level resignations in the administration, government shutdowns over the border wall, and even talk of the President removing the Fed Chair. The market detests uncertainty and reacted accordingly. However, the world is not coming to an end. Corporate profits are still rising, the economy is still growing (likely slower in 2019 though), employment is still strong, household debt is in good shape, the yield curve has not inverted, and valuations are now very reasonable.

Our best guess for the year ahead is continued volatility. We have begun to take advantage of this volatility by adding new names that meet our Three Pillar criteria for investment: Superior Business, Exceptional Management, Reasonable Valuation. This correction has allowed us to buy a few companies we think will perform well over the long term at very attractive valuations. As always, we continue to seek best-in-class ESG efforts, or willingness to do more, by the companies in which we invest.

Specifically, we bought utility and healthcare companies, a financial firm that profits from higher market volatility, as well as a sustainable infrastructure real estate company. The real estate company has a 37-year track record of profitability funding wind, solar and renewable energy projects. In depth detail about our performance and positioning can be found in the attachments below.[1]

There is a difference between price and value. Value is what something is worth, and price is what you pay for that value. The market may continue to decline, but we are certain that the portfolios we manage are currently priced below their true long-term value. We hope you had a nice holiday season and wish you a happy new year!

All the best.

Adam Cindy Laura Matt Nathan

[1] We've been told our letters are too long and have shortened this one so that it can be read during a commercial break in case anyone still watches live TV. Below are details on our two strategies.

SMID Strategy

Small- and mid-cap stocks had a rough quarter. The Russell 2000 index of small companies declined 20% from its most recent high, entering bear market territory. We were able to outperform our benchmark, the Russell 2500 Value and ended up besting it for the entire year.

We were quite active in the quarter with half of all our trading for the year occurring in the last three months. Turnover for the year was annualized around 20% before the quarter but ended the year at 33%.

We positioned the portfolio more defensively in early October by selling three positions and trimming one back. Using those proceeds, we bought two utilities, NorthWestern Corp (NWE) and Pinnacle West Capital Corp (PNW), as well as an infrastructure company, Hannon Armstrong Sustainable Infrastructure (HASI).

NorthWestern Corporation provides electricity and natural gas to customers in Montana, South Dakota, and Nebraska. More than 50% of their generation portfolio is carbon free. Pinnacle West Capital Corporation (d/b/a Arizona Public Service Company) is Arizona's largest public utility. They also have 50% carbon-free generation and a target to reduce carbon intensity by 23% over the next 15 years. Both utility companies are defensive investments due to their consistent earnings and attractive dividend yields of over 3% each. They are both sustainability leaders and operate in coverage areas with growing populations, thus providing significant growth opportunities.

Hannon Armstrong Sustainable Infrastructure Capital provides capital and services to the energy efficiency, renewable energy, and other sustainable infrastructure markets. HASI is structured as a REIT and pays a +6% dividend yield. It is defensive given its stable customer base of primarily governments and investment grade utility/industrial companies. In the last recession the company did not report a credit loss and has been profitable for the last 37 years. Every HASI investment must be carbon neutral or negative, and management tracks the progress of these investments through its proprietary CarbonCount® metrics.

As the market weakened throughout December, we took advantage and bought two new ideas as well as added to Abraxas, an existing holding.

Zebra Technologies Corp. (ZBRA) designs, manufactures, and sells a broad range of products serving the Automatic Identification and Data Capture (AIDC) industry, including but not limited to barcode/label specialty printers, supplies/consumables, and software. The importance of supply chain optimization has been elevated across industries with the Amazon effect. This will drive secular demand for ZBRA products as companies increasingly focus on working capital management (fulfillment, order/ship cycles, inventories), product availability & selection, and service levels. The stock is attractively valued at 13x 2019 EPS, given expected 6-8% revenue and double-digit earnings growth over the next few years.

Steris (STE) is a leading provider of infection prevention and other products and services, serving primarily the health care, pharmaceutical and medical device markets. STE products include sterilizers and washers, surgical tables, lights; consumable products such as detergents and endoscopy accessories and many other products. The next time you visit a doctor's office keep an eye out for them. The company generates prodigious free cash, fueling sales and dividend growth (double-digit since inception). The company conservatively expects organic revenue growth of 5% and earnings growth of 14%.

We also added to our position in Abraxas. Abraxas is down 70% from its price in May, yet we believe the long-term value has not declined anywhere near that amount, if at all. The stock ended the 3rd quarter flat but then sold off quite hard over the past three months. We added to our position in late December after the company gave a positive update on their operations.

We strive to outperform by a considerable margin in bad markets and keep pace in up markets. This year we trailed our benchmark for most of the year as markets hit all-time highs and we just squeaked by it in the downturn. We are happy to have outperformed in the quarter but would have liked to have gained more ground. We had a few stocks that have been absolutely pummeled like Abraxas. In a focused portfolio like ours, one decision on one stock can make a huge difference.

After analyzing our decisions over the year, we found that overall (up to now…) we were pleased with the ones we made. On an average equal-weighted basis the stocks we sold ended the year down 19% and the stocks we bought ended the year down 1%. These moves helped our performance by a substantial amount.

Large Strategy

Large capitalization stocks declined in Q4, but less so than small and mid-capitalization stocks. Relative to its benchmark the Russell 1000 Value, our Large Strategy performed in-line for the quarter and outperformed over the course of the year by a nice margin.

We were quite active on the trading front in the quarter; we sold four positions, bought a new one and added to American Electric Power, an existing holding.

Early in the quarter we sold Paccar, FIS, Capital One and Tapestry. We felt that the names were too cyclical and wanted to reallocate to companies that have more stable cash flow streams. In the short-term, these moves were positive as the stocks sold declined on average 13% from when we sold to the end of the year.

We only bought one new company in the quarter. ABB Ltd. (ABB) manufactures and sells electrification, robotics, industrial automation, and power grid products worldwide. It just announced the sale of its power grids division to Hitachi for proceeds of $9.1 billion which will streamline the company to become more of a pure industrial automation and electrification play. It is committed to decarbonizing its operations with a target to reduce their greenhouse gas emissions 40% by 2020.[2]

ABB trades for less than 13x earnings and pays a nice dividend that currently yields 4.4%. The company currently has 10% operating margins with the power grids business but over time, as ABB works to improve their model, we anticipate it should reach operating margins more similar to peers like Rockwell Automation (18%) and Fanuc Ltd. (31%). Such improvements should move ABB's stock price materially higher.

Our watchlist for new ideas has grown and we would expect that buys would outpace sales in the months ahead.

[2] https://new.abb.com/docs/default-source/sustainability/abb-group-sustainability-report-2017.pdf