STRAIGHT A'S & SUSTAINABILITY

When you bring straight A's home from school you don't have much explaining to do. That was 2019 for financial markets. Most major indices were up more than 20% and bonds rallied in concert with stocks. The decade exited with a bang as the S&P 500 closed with a plus 13% annualized return - well above its historic average. It is truly amazing that such significant changes can occur in a relatively short span of ten years. Back in late 2009 no one was buying Christmas presents or watching Home Alone on their smartphones.

Scientists largely believe that Homo Sapiens have been on the planet for about 195,000 years. It took about 150,000 years for the "Great Leap Forward" when people began burying their dead and using animal hides for clothing. Skipping forward another 40,000 years, or 10,000 years ago, agriculture developed and spread.[1] It then took another 5,000 years for writing to develop. Finally, some 5,000 years after that we got the iPhone! (There you go – the history of the world in one short paragraph).

Ten years ago, we were just coming out of the Great Recession. Not many would have guessed that the S&P 500 would triple in value over the ensuing decade. In fact, many predicted that the aughts would bring "more of the same dose of pain in terms of crashes, volatility, and economic calamities."[2] One lesson gleaned from the past decade is that it is a fool's errand to try to time the market. Since 1928, 66% of the time the S&P 500 has risen in any given year. Years ending in zeroes and ones actually have the worst record as odds of an up year drop to 44%.[3] Still, not bad.

There are no large red flags today in the economy - unemployment rates are low, inflation is tame, the Federal Reserve is accommodative and investment bubbles (think housing or tech stocks) are seemingly non-existent. Earnings growth in 2019 is looking to be at best flat and so all of the returns in the market were driven by higher multiples. Valuations are above long-term averages and, as such, we do not expect to see another round of higher prices paid for the same earnings stream. Therefore, higher stock prices will require a return to earnings growth. Analysts are forecasting 5% earnings growth in 2020 which, when combined with dividends would be a respectable year.[4] We'll give this a 44% chance of happening.

The trade war with China has simmered down, but Iran has taken its place in the headlines. The market so far has shrugged it off and other than oil prices inching up there is unlikely any major impact to the US economy. (Famous last words?)

As we said, it is a fool's errand to time the market by making short-term predictions about its direction (we still try for fun). What we are 100% confident in predicting is the direction of responsible investing in 2020 – UP!

The world faces a host of environmental and social challenges. The environmental impact alone has been estimated to cost into the trillions for the largest public companies in the world.[5] With nonprofits and government organizations unable to solve all these problems on their own, private industry has become

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[1] https://www.newscientist.com/article/dn9989-timeline-human-evolution/

[2] https://fortune.com/2019/12/17/investing-decade-in-review-s-p-500-tech-fed-interest-rates/

[3] https://www.bespokepremium.com/think-big-blog/us-stock-market-performance-during-years-ending-in/

[4] https://www.barrons.com/articles/sp-500-earnings-fourth-quarter-preview-51578940749

[5] https://www.nytimes.com/2019/06/04/climate/companies-climate-change-financial-impact.html

a crucial player in making the world a better place. A keen realization of this reality led Kofi Anan to find the United Nations Principles for Responsible Investment (UN PRI) in 2006. Over 4,500 companies around the world have signed onto the UN Global Compact, which advocates using "Business as a Force for Good.[6]"

Publicly traded companies are taking leadership positions in combating climate change and important social issues. They realize that ESG (environmental, social and governance) factors may present significant risk and/or opportunity for all stakeholders of the organization. Today 86% of S&P 500 companies address ESG issues in sustainability reports published annually (vs. 20% in 2011).

In 2019, flows into ESG funds more than tripled vs. 2018 as investors gained awareness of the need for businesses to consider ESG factors, particularly given the fact that companies that do tend to outperform over time.[7]

At Riverwater, we seek best-in-class ESG efforts; additionally, we engage with companies to improve their efforts, and our work is generating impact. This "ESG momentum" offers the greatest opportunity to improve society and generate superior financial outcomes.

RIVERWATER SUSTAINABILITY EFFORTS

Our mission at Riverwater Partners is to grow wealth and make the world a better place through sustainable investing. We believe if we are going to advocate that the companies we invest in operate sustainably, we must do so as well. To that end, as most of you know, we are the only financial firm in Wisconsin that is a Certified B Corp® and this past year we signed on to commit to the B Corp's Net Zero by 2030. We do not have a large carbon footprint, but every little bit helps, and we will have to consistently consider ways to reduce our environmental impact.

We already recycle all paper and plastic and compost our food waste with a goal of 100% diversion from landfills. We use lights sparingly in our office given our floor to ceiling windows and are proud to be in a building with solar panels on the roof. We recently invested in tablets to reduce our paper usage when making presentations and also purchased two electric scooters and a bike to commute around town when feasible in place of using our cars. We have received the Wisconsin Green Masters certification in 2018 and 2019 for our efforts.

Riverwater is an active member of the UN PRI, US SIF, Ceres, CDP, ICCR, and SGI. (We are happy to discuss what this alphabet soup of organizations do if you are interested). Collaboration with these thought leaders informs our practice and allows us to partner in engagement and policy formation. We are proud to play an active role, including committee and/or board membership, in several of these organizations.

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[6] https://www.unglobalcompact.org/what-is-gc/participants/search?utf8=%E2%9C%93&search%5Bkeywords%5D=&search%5Borganization_types%5D%5B%5D=5&search%5Bper_page%5D=10&search%5Bsort_field%5D=&search%5Bsort_direction%5D=asc

[7] https://www.wsj.com/articles/esg-funds-draw-sec-scrutiny-11576492201?mod=mktw

RIVERWATER SMID STRATEGY

On an absolute basis, our SMID (small and mid) cap equity strategy had positive returns yet underperformed our benchmark by more than we would like. We covered the underperformance in our last letter and after analyzing what mistakes were made, have spent considerable time learning from them and making sure we don't make them again.

In our Q3 2019 letter, we discussed Verso and Abraxas – both commodity-based companies. We saw a nice rally in Verso from the lows in the third quarter to where it nearly doubled in price in less than 90 days. Abraxas has not been so fortunate and continues to linger at decade-low levels. They have hired an investment bank and we believe the best outcome is to sell or merge the company with a larger player that can leverage their cost base.

One minor victory for us was that we did get a response from Virtu on board diversity who said they are open to interviewing diverse candidates when the next position is open.

We target investment horizons in the years as opposed to quarters and were not very active on the buy or sell side. We ended the year with a turnover ratio just under 30% which puts our average holding period around 3 years. The only buy we executed in the fourth quarter was a purchase of Rosetta Stone. We sold Avnet to fund the purchase. Avnet lost a major customer and our patience in the name wore out after having owned it for three years with essentially no capital appreciation.

Rosetta Stone (RST) is a software company best known for its yellow boxes containing foreign language instruction CDs. The company still offers language learning – via apps today – as well as language learning tools for professionals and ESL learners. Most importantly, RST has created a reading/language software tool for use in the classroom. Schools using it have reported huge success in reading ability of their students – it is typical for 65% of students in a given school to read below grade-level; after one year of using Rosetta Stone's Lexia software, that number drops to 10%. We believe this tool will be a driver of future growth, and also will leave a meaningful impact on society, helping RST score well on our ESG scoring metric.

We are currently working on some promising ideas in the industrial space and expect a new name or two before the first quarter ends.

RIVERWATER LEI STRATEGY

On an absolute basis, our LEI (large equity income) strategy ended up positive yet, like the SMID, trailed its benchmark by more than we would like. We were slightly busier in this strategy in the fourth quarter but still ended the year with a turnover ratio of just under 20%. We sold two stocks and bought four in the fourth quarter.

Nokia (NOK) was sold after the company cut its 4Q 2019 and 1H 2020 guidance and paused its dividend. We believe NOK is well-positioned to benefit from the rollout of 5G wireless networks globally; however, several factors, including lack of approval of the T-Mobile/Sprint merger, a pause in spending by carriers as they evaluate vendors, and an internal production issue at Nokia have led to a delay in revenue and profit recognition. Therefore, we felt it was prudent to sell the stock until visibility is clearer.

Church & Dwight (CHD) was sold during the quarter as well. 2019 saw a move toward defensive sectors like Consumer Staples, which benefited our consumer staples companies, including CHD. We sold CHD given our concern that the stock was richly valued relative to its peers. In addition, we became concerned about the quality of its earnings and management's ability to navigate the more competitive environment in its end markets.

We replaced Nokia and Church with a drug maker and an industrial conglomerate.

GlaxoSmithKline (GSK), headquartered in the UK, is a science-led healthcare company focused on Pharmaceuticals, Vaccines, and Consumer Health. Under new leadership, GSK has begun to refocus its portfolio, partnering with Pfizer to combine and streamline their consumer businesses, which will be spun-out as a separate entity in three years, allowing them both to focus on pharmaceuticals. GSK has the world's largest vaccines portfolio, and there are several new launches planned. This new focus on sustainable (GSK scores very high on our proprietary ESG scoring metric) growth offers opportunity for shareholders.

United Technologies (UTX) has four main businesses in elevators (Otis), air conditioners (Carrier), jet engines (Pratt & Whitney) and flight controls (Collins). We love the elevator business! Otis is a dominant global player and is going to be spun out of the company this year. Once an elevator is installed it is cost prohibitive for the building owner to ever switch providers during the elevator's useful life. There are long-term service contracts that have pricing power and no high rise today is built without one. When you compare the valuation that the market places on Otis under the UTX umbrella versus other publicly traded elevator companies there is plenty of upside potential.

United also scores very well on our ESG scoring metric. Since 1997 they have lowered GHG emissions by 35% and water consumption by 62%, all while growing sales 3x. Their products have focused very much on sustainability; their new jet engine reduces fuel burn by 16% and NOx emissions by 75%, their new Gen2 elevator reduces energy consumption by 75%, and their Carrier screw chiller is 42% more efficient than the industry standard. Women today hold 30% of senior leadership positions and the company targets 50% by 2030.

We also added to our financial holdings, adding two insurance companies.

The Progressive Corporation (PGR) provides personal and commercial auto insurance, residential property insurance, and other specialty property-casualty insurance and related services primarily in the United States. You may know Flo. PGR is the market leader in segmenting risks. This allows it to allocate premium pricing to the riskiest customers and helps it retain its safest customers. PGR's expertise has allowed it to consistently outperform peers on return on equity and combined ratio metrics. Management plans to bundle homeowners and auto to broaden its demographic reach and increase its penetration among relatively affluent customers. Efforts to run an environmentally responsible business put PGR in Newsweek's Green Rankings. They've made each published list since 2012.

Aflac Incorporated (AFL) - you may know the duck - provides voluntary supplemental health and life insurance products. It operates through two segments, Aflac Japan and Aflac US. Aflac Japan is roughly 70% of sales and is unique because of its relationship with Japan Post, which owns 5% of AFL. Japan Post is like the US Postal Service, but with additional services including partnering with AFLAC to sell insurance to Japanese citizens. As with PGR, AFL has above average operating metrics based on return on equity and combined ratio. Also, AFL is more defensive than most companies since 70% of its business is in Yen, which is a safe haven currency. AFL’s ESG efforts are well recognized as it was named one of the world’s most ethical companies by Ethisphere Institute for 13 consecutive years.

THE SECURITIES IDENTIFIED HEREIN ARE NOT A RECOMMENDATION TO BUY OR SELL AND IT SHOULD NOT BE PRESUMED THAT THEY WERE OR WILL BE PROFITABLE.