Riverbridge™

INVEST WITH ENDURANCE™

INVESTMENT PERSPECTIVES

4TH QUARTER 2017

MARKET COMMENTARY

Rick D. Moulton, CFA, Portfolio Manager

With 2017 now on the books, investors are hoping for a repeat performance in 2018. Most major market indices posted returns in excess of 20% for the year. Robust global economic growth coupled with strong corporate earnings fueled the equity markets. Amazingly, the S&P 500 index went the entire year without delivering a single monthly loss to investors. Investors were able to enjoy these handsome returns without having to endure a bumpy ride. Volatility was docile. Only eight times in 2017 did the S&P 500 produce up-or-down daily moves of 1% or more – the fewest since 1965. These strong returns coupled with low levels of volatility may surprise someone watching the nightly news featuring North Korean tumult, dysfunction in Washington D.C. and numerous natural disasters in 2017. As we look ahead, the ingredients that propelled the markets in 2017 largely remain intact.

We encourage our readers to avoid the pitfalls of market timing. Many prognosticators are attempting to call the top of our current bull market. The vast majority will be wrong. Riverbridge does not attempt to forecast the markets. We instead channel our efforts on identifying and investing in companies that are well positioned to thrive in their respective markets.

The year began with a new presidential administration with starkly different priorities than the previous administration. Some feared an injurious trade war. Others were optimistic that President Trump's policies would be welcomed by Wall Street. Early on it became evident the two primary objectives of the administration in 2017 were the repeal of the Affordable Care Act and the passage of tax reform. After much drama with both, the administration achieved one of its major goals: tax reform. In the end, as it relates to the markets, it did not much matter. As President Clinton's campaign famously proclaimed in the 1990s: "It's the economy, stupid."

The strong global economy simply overwhelmed many of the investment risks that consternated investors. These risks included valuations of equities, inflation and geo-political uncertainty. The economy grew at its fastest pace in years and unemployment is at a 17-year low.

Making this backdrop more impressive is the absence of inflation. Inflation remained stubbornly below the Federal Reserve's target rate of 2%. Fed Chair Yellen described the absence of inflation as a "mystery." Ultimately corporate America delivered another year of strong earnings growth and was largely joined by the rest of the world.

Larger cap stocks continued their dominance of their smaller counterparts. A key factor driving the strong performance of large multinational firms was the behavior of the dollar. After years of strength, the dollar exhibited weakness. This weakness helped to boost corporate profitability and make exports cheaper. It was the worst year for the dollar in a decade.

As we look ahead to 2018, corporate earnings will continue to be a key factor that determines the trajectory of the equity markets. However, investors will carefully observe the impact of two other major stories. In February, Jerome Powell will succeed Janet Yellen as the Chair of the Federal Reserve. Investors will watch for clues signaling any shifts in policy. It is expected, however, the incoming Chairman will follow a very similar path his predecessor previously charted.

The second major event will be the midterm elections. The Republicans, who currently control majorities in both the Senate and the House of Representatives, are almost guaranteed to lose seats. On average since the Civil War, the current president's party has lost 32 House seats and two Senate seats. If this holds true in 2018, the Democrats will wrest away control of both branches of the legislature and thus complicate President Trump's agenda. Though a major story, we expect the midterm elections to have little impact on the markets.

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FEATURED REPORT

An Enduring Investment Approach is Rooted in What's True

Rick D. Moulton, CFA, Portfolio Manager

At the heart of any sound investment strategy rests an investment philosophy. An investment philosophy, simply stated, is a set of guiding principles that govern all investment decisions made by an entity.

Most investment managers promote their own unique investment philosophies. The philosophies of value managers usually center on identifying undervalued stocks that will ultimately become appreciated by the market. Other philosophies may focus on a combination of risk and reward elements the portfolio manager believes will generate superior returns. Riverbridge believes many different philosophies can be deployed effectively. However, few philosophies have outlasted our time-tested, earnings power-based discipline.

Most of our loyal readers are familiar with the Riverbridge investment philosophy, which is rooted in the belief that earnings power determines the value of a franchise. We invest in high quality growth companies that demonstrate the ability to sustain strong secular earnings growth over long periods of time, regardless of overall economic conditions. For more than 30 years, this philosophy has been our guiding principle, enabling our portfolios to establish compelling risk-adjusted returns for multiple decades.

At Riverbridge, we believe what is true endures–in investments, people, and companies. Our investment philosophy remains as relevant today as it was the day we opened our doors in 1987. But, the genesis of our philosophy dates to the 1960s. Over this time, investors have witnessed many market environments, trends, and even manias. The 1970s featured an inflation-ravaged market that tested the patience of many investors. The euphoric dotcom market of the 1990s delivered investors outsized returns until its bubble popped at the beginning of the 2000s. The financial market crash of 2008 created challenges not seen since The Great Depression. Throughout these markets, the guiding principles of our investment philosophy have withstood these challenges.

Our investment team seeks well-managed businesses with diversified sources of earnings generating high returns on their invested capital. The management teams of Riverbridge portfolio companies have the fortitude to resist the short-term pressures of Wall Street. They refuse to prioritize near-term results when doing so would jeopardize the long-term health of the franchise. Our portfolio companies tend to reinvest capital in themselves to build their earnings power. Regardless of the current market climate, the management teams of our portfolio companies are actively positioning themselves to thrive over the next decade as opposed to the next quarter. While our conservative growth style may cycle out-of-favor over short periods of time, the enduring disciplines of our philosophy have allowed our strategies to perform well on a risk/reward basis over entire market cycles.

The true test of an investment philosophy is whether it would survive in the private markets. Yet many philosophies instead seek to exploit a current public market inefficiency. In the 1990s, many styles were created to exploit what was commonly termed "The New Economy". Once investors realized that - while displacements may occur - economics do not change, these philosophies soon vanished. More recently we have witnessed quantitative strategies deploying algorithms seeking to outperform markets on a quarterly basis. Interest rates, inflation, global growth are just a few of the many inputs that factor into their models. Once these inputs change, the algorithms that govern these philosophies are disrupted and require updates.

The Riverbridge philosophy is as valid when investing in private companies as it is when investing in public entities. We invest in companies possessing an enduring competitive advantage in their marketplace. Our portfolio companies are not dependent on borrowing and hold a dominant market position. Using time as their friend, these types of companies are rewarded for their advantaged capital. We are not attempting to exploit a transitory inefficiency in the public markets but rather making investments in sound companies benefitting from compounding, above-average unit growth for long periods of time.

The consistent application of a sound investment philosophy is the key for any investment manager seeking to deliver superior risk adjusted returns. While this concept may seem straight-forward, its deployment is not. The ability to resist near-term market emotions and not deviate from their stated investment philosophy is what separates enduring managers from those that come and go based on short-term market phenomena. While markets may be volatile and ever changing, Riverbridge clients can be assured that our investment philosophy will continue to be at the heart of our investment process.

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