Riverbridge™

INVEST WITH ENDURANCE™

INVESTMENT PERSPECTIVES

1ST QUARTER 2018

MARKET COMMENTARY

Rick D. Moulton,
CFA, Portfolio Manager

Perhaps the best market mantra to describe the first quarter of 2018: How quickly things can change. The markets began the year on a strong note surging nearly ten percent over the first three weeks of trading. Seemingly in a flash, the mood of the market shifted. Replacing the euphoria of January was record setting volatility. Gone was the placid environment of 2017 whereby seldom did the markets move more than one percent in a day. Investors witnessed the evaporation of the year's early gains and watched as the markets moved into correction territory–down ten percent from recent highs. In the end, both the Dow Jones Industrial Average and the S&P 500® Index posted quarterly losses for the first time since 2015. For the first time in ten quarters, investors are forced to ponder whether the previous quarter's losses are merely an aberration or foretelling of future market struggles.

It is difficult to imagine a better start to the year than what January offered. Fueled by impressive fourth quarter earnings reports, the markets got off to a quick start. In what has become a hallmark of this lengthy bull market, technology stocks led the way higher. In addition to a strong earnings season, economic reports were placid and provided investors with no reason for concern.

In late January, market sentiment began to change. Data emerged suggesting possible signs of wage growth inflation. Though unemployment rates have consistently hovered near 17-year lows, somewhat remarkably we have witnessed very little wage growth inflation. The market was on edge as new Federal Reserve Chair, Jerome Powell, took the helm. The Fed promptly lifted interest rates for the fifth time since December 2015. Adding to market angst, President Trump imposed tariffs on steel and aluminum imports stirring fears over a possible trade war. These apprehensions ignited volatility. According to the Wall Street Journal, the VIX® Index, a gauge for market volatility, posted its sharpest rise on record. To place this increased volatility into better perspective, the S&P 500 Index has experienced almost twice as many daily moves of one percent or more in 2018 as it did the entire year of 2017.

Large cap technology stocks, particularly the so-called FAANG stocks (Facebook, Amazon, Apple, Netflix, and Google), have been Teflon coated during most of this bull market. These companies and their investors have been adept at quickly shedding any type of concern or worry that may impact their stock prices. During March, however, some of these stocks displayed cracks in their armor. Facebook was accused of mishandling sensitive customer data and offered a rather clumsy response. Amazon got caught in the crosshairs of President Trump as the company became a frequent target of his Twitter account. FAANG stocks currently constitute approximately 15% of the S&P 500 Index. When they are under pressure, it presents a formidable obstacle for the Index itself to advance. Passive investors learned this painful truth in the first quarter.

> Economic growth–both domestic and global–should continue to post moderate advances with only modest levels of inflation. Investors are generally well served to ignore short-term anxieties and remain focused on their long-term objectives.

It is understandable for investors to view the remainder of the year with some level of trepidation following the market events of February and March. However, major reasons abound for optimism. Within April, first quarter earnings will be reported. According to Factset, earnings should grow 17% making it the best quarter for the S&P 500 since 2011. This earnings growth will help ease valuation concerns. Economic growth–both domestic and global–should continue to post moderate advances with only modest levels of inflation. Investors are generally well served to ignore short-term anxieties and remain focused on their long-term objectives.

Riverbridge remains optimistic regarding our portfolios. Increased volatility, though at times unnerving, is not necessarily bad for the markets. It forces investors to better distinguish between companies deserving of increased capital and punishes those investors indiscriminately investing simply in a basket of securities. Should borrowing costs increase due to rising interest rates, our internally financed companies are well insulated. Should we see inflationary pressures increase, our portfolio companies can pass these increased costs onto their customers. Most importantly, the management teams of our portfolio companies are expert at adapting to the ever-changing global economic landscape.

Defining Growth through Earnings Power

Rick D. Moulton,
CFA, Portfolio Manager

We are fast approaching the date that will mark our current bull market as the longest in history. During this time, the global economy has generally featured modest growth with low levels of inflation. Also, during this record setting period, the global markets have inundated the global economy with "easy" money. Access to abundant capital encourages companies to accept greater risks for growth. We have witnessed numerous companies expand their businesses into adjacent markets or even new markets in which they do not necessarily possess a competitive advantage. Wall Street is largely pleased as these companies can demonstrate impressive short-term growth–both top and bottom line.

We hear the term "growth" constantly in our industry. Generally speaking, investors desire "growth" from the companies or assets in which they invest. This makes sense. After all, growth is normally required to make assets more valuable. Even value-oriented investors seek out companies that exhibit the potential to grow in the future.

But how do you define growth? Some investors define growth simply as revenue growth. Some focus on increasing profits or earnings per share. Margins, market share and many other metrics may be used as barometers of growth. All growth, however, is not created equally.

Enduring investments ultimately require companies to sell more of what they do. Many of our long-time constituents are aware that Riverbridge defines growth as unit growth. We invest in companies that consistently sell more of what they do year after year. The definition of units varies from company to company and can include the number of licensed seats for a software company or products sold for a manufacturing company.

Many managers use some level of profitability–such as net income or earnings per share–as their primary measure of growth. While these measures are an important piece of a company's overall analytic mosaic, they have limitations. Companies may increase their profitability through cost reductions. Costs can only be pared so far, however, before the fundamental vitality of a company is compromised. For ultimate sustainability, unit growth must be present.

Unit growth alone also has its limitations. Growing for growth's sake is a recipe for an underperforming investment. Riverbridge is not attracted to management teams whose aim is to grow at all costs. Instead, we focus on companies that are producing enduring unit growth while maintaining high returns on invested capital. We focus on management teams deploying their resources in a manner that will earn them a sustained superior return on their invested capital. We are willing to accept reduced revenue or earnings per share growth if management makes prudent investments in those parts of their businesses which can generate high returns over the long term. Sustained unit growth combined with increasing returns on invested capital creates earnings power.

> Riverbridge seeks management teams with the discipline to stay in businesses and allocate capital only to where they have an advantage.

Riverbridge seeks management teams with the discipline to stay in businesses and allocate capital only to where they have an advantage. For management teams of public companies, the pressure from Wall Street to accelerate short-term growth is formidable. Too many company leaders move into lower return businesses attempting to chase growth. To do this, they may apply leverage. Borrowing is an effective but risky method to bolster growth. Unless this incremental growth offers a superior return on invested capital, applying leverage increases the risk to the business at a rate not commensurate with the benefits of the increased growth.

As we look at today's state of the economy, while Wall Street may be generally pleased with companies that are demonstrating current short-term growth, when access to this cheap capital evaporates, these companies will suffer and will likely experience stalled growth. This phenomenon has occurred repeatedly throughout market cycles in 1990, 2000, and 2008. Thus, we find it critical to look at unit growth and lean on our investment philosophy while investing in companies with growing demand for what they do combined with achieving superior returns on their invested capital. ■