Riverbridge™

INVEST WITH ENDURANCE™

INVESTMENT PERSPECTIVES

2ND QUARTER 2018

MARKET COMMENTARY

Rick D. Moulton, CFA, Portfolio Manager

Investors have been presented this year with a myriad of market impacting confluences. The year began much like 2017—handsome returns with low levels of volatility. The end of January broke this idyllic calm. Since January 26th when labor data were reported and hinted at some inflationary pressures in the financial system, the markets have grown more volatile and less predictable. The economically stimulating tax cuts and robust corporate earnings are competing with anxiety producing trade skirmishes and rising interest rates. Stocks have been clearly divided—the winners are small cap stocks and the broader Technology sector. The rest of the markets have generally been relegated to the laggard category. As we look ahead, volatility promises to remain as we begin to inject more political dynamics into the marketplace.

The Nasdaq when compared to the Dow Jones Industrial Average® or the S&P 500® indexes offers a startling juxtaposition concluding the quarter by flirting with fresh new highs. Meanwhile both the S&P 500 and Dow are languishing well below their late January high water marks. The market narrowed greatly and the Technology sector and the so-called FAANG stocks are disproportionately propelling the Nasdaq while offering a lessor benefit to both the Dow and S&P indexes.

Smaller cap stocks continue their resurgence outperforming their larger counterparts. Motivated by trade war fears, investors embraced these stocks over beliefs they are more resistant to the impacts of tariffs and slowing foreign growth. Because they tend to derive less revenue from abroad, small companies have relatively benefited during this period. Additionally, investors are favoring small cap stocks because they are benefitting more from the tax code overhaul.

Corporate earnings remain strong. First quarter earnings reported during the second quarter rose nearly 20%. Strong domestic economic growth coupled with benefits from corporate tax cuts catalyzed earnings growth. For the first time in the history of our economic data, there are more job openings in the United States than there are unemployed people.

Trade rhetoric promises to dominate market headlines for the rest of the summer and possibly longer. Should a full-fledged trade war come to fruition, global economic growth will almost certainly be suppressed. The implications are great for those companies generating substantial revenues overseas. According to FactSet, the Dow Jones constituents in aggregate derive 44% of all sales overseas compared to 30% for the S&P 500. More potentially threatening to this current market environment is the exposure of the market leading Technology sector which derives 59% of their collective revenues from overseas. Up to this point, technology companies avoided most of the discussed tariffs. However, suppressed global economic growth will almost certainly adversely impact their sales.

As we look ahead, volatility promises to remain as we begin to inject more political dynamics into the marketplace.

The Federal Reserve continues to play a key role in shaping the direction of the markets as they continue their policy of monetary normalization. Under new Fed Chair Jerome Powell's leadership, we have not seen any surprises as he has slowly, but consistently raised rates. More concerning to economists and market observers the yield curve has been flattening. The gap between the two- and 10-year Treasury yields is now at its lowest level since the summer of 2007. Observers fret over an inverted yield curve when long-term debt instruments yield less than their shorter-term counterparts. An inverted yield curve preceded each of the last seven recessions.

The prospects are bright for longer-term investors like Riverbridge. Market participants will continue to consternate over the prospects of inflation, rising interest rates, decelerating global growth, and trade wars. Added to this market volatility inducing cocktail in the second half of the year will be the angst over the appointment of a Supreme Court justice and mid-term elections. Short-term oriented investors, which now comprise the majority of market participants, will be vulnerable to emotional decisions based on these anxiety producing factors.

Riverbridge invests in less economically sensitive companies that are not nearly as susceptible to rising rates of inflation or interest. More importantly, our portfolio companies are managed by leaders focused on delivering superior long-term risk adjusted returns to their shareholders. Because of this long-term orientation, our management teams can more effectively navigate the more turbulent economic waters. ■

Identifying Sustainable Growth

Rick D. Moulton,
CFA, Portfolio Manager

Growth is generally coveted by investors. Most investors seek some type of growth—growth of markets, revenue growth, earnings growth, market share growth. We view growth as an important concept as well but are differentiated from many of our peers in that we define growth as unit growth. We take this view as enduring investments ultimately require companies to sell more of what they do today. While few dispute growth is a necessary ingredient for capital appreciation, an oft-neglected piece of analysis is the sustainability of such growth, which requires a deep look at a company's strategic market position. To understand if a company is well-positioned for long-term leadership and growth within its industry, Riverbridge believes it is necessary to analyze a company's strategic market position.

For starters, it is important to understand and clarify the difference between a company possessing a strategic market position versus a dominant market position. Broadly defined, a dominant market position is a company with either the largest or second largest market share. Companies with a strategic market position, however, look far beyond their current market position. These companies possess many components beyond purely position, such as a defendable market niche or the ability to transform an entire industry. While a transformational company may have a small market share, with the promise to revolutionize an entire industry, a company possessing a strategic market position must not be ignored in favor of those companies with a current dominant market position.

Riverbridge certainly has many portfolio investments that can lay claim to being the dominant player in their markets. However, possessing a dominant market share today does not ensure a future leadership position. History provides many lessons of market leaders failing. Think of Compaq, once the largest supplier of personal computers in the 1990s. Eastman Kodak was regarded as the undisputed leader in all things photography. Sears was the dominant retailer and Blockbuster dominated the home movie marketplace. While these companies once had a dominant market position, they lacked a strategic market position. Investing in companies simply possessing a dominant market position is not sufficient if these companies are culturally ill-equipped to maintain such market leadership.

Riverbridge focuses on identifying portfolio companies strategically positioning themselves in their markets so their brands, products, or services have a clear differentiation amongst their peers, allowing for enduring growth and difficulty being displaced. The primary factor Riverbridge considers when assessing a corporation's market positioning is endurance. Strategic market positions endure.

Companies competing primarily on price are vulnerable and likely do not operate within a defendable niche. Companies possessing strategic market positions are difficult to disrupt. They have something that is very difficult to replicate: earned trust. In many instances, these companies may not have the best product. However, they deliver a level of service that is almost impossible to match. One of the most admired companies in America for over three decades is Fastenal. Simply stated, Fastenal is literally a nuts and bolts company, yet has thrived in a seemingly commodity-oriented business by delivering unrivaled customer service. To have a specialty fastener delivered to a particular worksite in a short period of time is of tremendous value to the customer. What Fastenal is actually selling is unparalleled customer service—not nuts and bolts. Much larger competitors have been unable to dislodge Fastenal through offering their products at lower prices.

Additionally, companies possessing a strategic market position are able to earn and sustain a superior return on their capital. They are not forced to compete merely on price. As a result, they have tremendous pricing flexibility. Should we continue to see signs of rising prices in today's markets, it will be of paramount importance for companies to pass through rising input costs. Companies not operating within a strategic market position will struggle to do so.

A strategic market position is essential for enduring growth. Enduring growth requires sales that are not solely dependent on selling a good or service at a lower price than a competitor. The insistence Riverbridge portfolio companies possess a strategic market position enables our team to have confidence our portfolio companies will not be easily displaced within their competitive marketplace. Strategic market positions are difficult to earn and an even bigger challenge for a competitor to displace. The challenge to find such companies is well worth the difficulty. This discipline deserves much credit for our compelling 30-plus-year investment track record for our strategies. ■