

INVESTMENT PERSPECTIVES

3RD QUARTER 2018

MARKET COMMENTARY

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Conventional wisdom did not hold in the third quarter of 2018. The summer months have earned a reputation over many years as being challenging for equity investors, with September being the most difficult month historically. Not this year. Instead, the markets generated their best quarterly return since 2013. In August, the markets officially reached a milestone, the longest duration bull market. Fueling these market advances were robust corporate profits and a vibrant domestic economy. The rest of the world, however, did not participate in this advance. Also remarkable, we witnessed the first United States publicly traded companies to surpass the trillion dollar mark as measured by market capitalization in Apple, Inc. and Amazon.com, Inc. As we move into the fourth quarter, market-driving fundamentals remain strong. Elevated investor expectations may serve as the most significant risk to this near decade long bull market.

The primary factor driving equity prices higher are strong corporate earnings. On the heels of strong first quarter earnings of 25% growth, second quarter earnings surged a remarkable 25% again. Despite the handsome stock prices advances, hearty earnings growth keeps valuation concerns at bay. In addition to earnings, several other economic measures positively influenced the markets. Small business optimism reached its highest level on record according to the National Federation of Independent Business. Positive sentiment was not confined only to the corporate world. Consumer confidence reported its strongest reading since 2000. Our nation's unemployment rate reached its lowest level in nearly two decades. By almost any measure, the domestic economy continues to exhibit strength.

Rising interest rates and trade skirmishes did their collective best to derail the markets. The Federal Reserve implemented its third rate hike this year and its eighth such move since 2015. Furthermore, the Fed signaled continued rate hikes throughout 2019 to keep the economy from overheating, catalyzing inflationary pressures. Trade disputes continue to dominate headlines. Many economists fret about the earnings impact of restricted trade and tariffs. The North American Free Trade Agreement, or NAFTA, was effectively repealed, leaving much uncertainty

regarding trade with our two neighbors, Canada and Mexico. Early in the quarter, an agreement with Mexico was reached. An agreement with Canada proved more contentious but was also hammered out at quarter's end. Assuming Congress ratifies these agreements, investors should welcome the trade certainty this agreement promises. A trade deal with China remains elusive and does not appear imminent.

The fourth quarter promises to keep investors riveted. Their mettle will be tested early during the October earnings season. According to FactSet, corporate earnings growth will continue to be impressive but not at the eye-popping levels witnessed in the first two quarters of the year. Outlooks for 2019 will soon be issued. It will be interesting to observe the impact of the trade war on 2019 revenue and earnings estimates. As per usual, the midterm elections will prove contentious. Should both branches of the legislature change political party hands, the current pro-growth agenda will likely be altered. The fourth interest rate hike in 2018 will likely occur in December. The impact of higher borrowing costs on the consumer will be carefully monitored. High investor expectations, however, remain the single most significant threat to our bull market.

The Riverbridge strategies are well-positioned regardless of investor sentiment. Our investment team has supreme confidence the management teams of our portfolio companies will navigate the choppy waters

We invest in companies positioned to thrive over the next decade and thus we are not as susceptible to our management teams overreacting to short-term pressures on their end markets.

caused by trade uncertainty. Our businesses are not overly levered and consequently rising borrowing costs will have a muted relative impact on our companies.

While market returns may be volatile, the underlying businesses of our portfolio companies are not.

Assessing Management to Identify Endurance

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Loyal readers are by now well acquainted with Riverbridge's unwavering commitment to our investment disciplines. We seek companies with a strategic market position in their competitive marketplace, consistent unit growth, and high returns on invested capital. All are of paramount importance. Our investment team also insists on investing in companies, regardless of the economic backdrop, possessing the ability to internally finance their growth so as not to be dependent on the credit and capital markets. Inarguably, however, the most important investment discipline we deploy is our assessment of company management. Endurance demands strong leadership.

Riverbridge, unlike most market participants today, seeks to invest in companies for multiple years, and some, even decades. In fact, across our portfolios we have invested with greater than 25% of our companies for more than ten years. Over this long time period, many variables change. Geopolitics shift. Interest rates and inflation ebb and flow. Investors celebrate bull markets and cope with bear markets. Too many management teams lose their way while attempting to navigate these events and the ever-changing landscape. Due to short-term performance pressures, management teams tend to prioritize execution and efficiency and often neglect their original reason for existence. This inattention to mission leads to a slow but consistent erosion of corporate culture. Strong management teams are needed to traverse these ever-changing conditions while executing their corporate missions.

For years, General Electric was a darling of Wall Street. This reputation was earned by their early and relentless focus on Six Sigma strategies to reduce manufacturing cost while improving profits. While this focus was successful at refining their production, General Electric ceased to be an innovator in its end markets. Today the company has surrendered its market leadership in many of the segments it serves.

On the other hand, Jeff Bezos, the founder and leader of Amazon, is constantly challenging his leaders to attempt new, innovative products and services while firmly understanding their founding mission is to deliver ever-increasing levels of service to customers. Amazon will disrupt themselves in their end markets long before a competitor will do so.

Riverbridge is separated from the pack by how we define quality management and qualify the leadership of our businesses. The truncation of the investor time horizon has caused the definition of "good management" to shift to near-term execution as opposed to long-term vision. Riverbridge strongly believes the adage culture eats strategy for breakfast. We invest in management teams focused on the next decade and beyond. Enduring investments require leadership to cultivate a culture encouraging and even demanding constant innovation - even if it comes at the expense of near term earnings. Expert management understands this sacrifice builds earnings power.

Riverbridge validates its assessment of management through our peer review process. Following extensive conversations and onsite visits with the management teams of prospective companies, our investment team conducts an exhaustive peer review. We meet with customers, suppliers, competitors, and other industry participants to gain their viewpoint of this management team. We seek to understand if differences exist between the way management views themselves compared to how they are perceived in their competitive marketplace. This discipline naturally leads us to management teams well respected in the eyes of their peers.

Fiserv, Inc. is a prime example of a company possessing a management team and a firm culture that allowed the company to thrive despite a massive transformation of the end markets they serve. Simply stated, Fiserv provides financial services technology to institutions such as banks and brokerage firms. These institutions witnessed dramatic progression of their marketplace requiring multiple disparate systems to communicate seamlessly. By never allowing themselves to lose sight of their founding mission to serve changing customers' needs, Fiserv strengthened its market position and grew into a Fortune 500 company during a period of upheaval that has felled many competitors.

With market displacements becoming increasingly common throughout the global economy, strong leadership is of paramount importance. Barriers to entry in many industries have been lowered due to technological innovation. Companies possessing visionary leaders will be able to better navigate their ever-changing landscape. These leaders understand and carefully cultivate their cultural advantage to retain talent and to develop an enduring soft edge within their business. Riverbridge will continue to seek out companies with strong leadership possessing the ability to traverse the continuously changing environment.

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