2016: Steady Returns in a Roiling Market

Greetings from Tufton Capital, where the tinsel has been packed away, the winter weather has formally arrived, and your team of investment professionals has been busy closing the books on yet another banner year.

Of course, for many investors, "banner" may not be the first word that comes to mind at the mention of 2016. Faced with one of the most turbulent years in recent memory, an unfortunate number of market participants spent the last twelve months swinging from one bout of paralysis to the next. After all, in between British referendums, American elections, and all the other stories that kept us on our toes, how could one have possibly anticipated what tomorrow had in store?

Put simply, one could not. And regardless of what the market's soothsayers would have you believe, that will remain the case in 2017. Perhaps, as some news outlets are quick to suggest, the broader economy will thrive under the coming administration, buoyed by the message that America is now "open for business." Or perhaps, as other outlets have asserted—with equal volume and vigor—our new president will prove uniquely problematic, unduly influencing the market one late-night "tweet" at a time.

Short of procuring a crystal ball (which I imagine was on many a wish list this holiday season), your team here at Tufton Capital has no way of knowing which of these scenarios is more likely to unfold. But here's what we do know: in a year marked by extraordinary surprises, this firm's diligent, value-based investment approach comfortably outperformed both our benchmarks and the market at large. At the risk of seeming boastful, that's no surprise to us.

Since our founding in 1995, it has been our firm's guiding belief that a good business, bought at a fair price, is among the most powerful wealth-creation vehicles in the world. Reflecting back on 2016, I'm pleased to report that this belief continues to keep you, our valued client, in good stead. As we enter into our second year under the Tufton Capital name, we look forward to providing you with the level of service, insight, and performance you've come to expect—no matter what comes around the bend. From all of us at Tufton Capital, here's to a Happy New Year for you and yours, and to our achievement of even greater success, together, in the year ahead. ■

Chad Meyer, CFA
President

Inside This Issue

The Fourth Quarter of 2016: Well That Changed Everything

ERIC SCHOPF
DIRECTOR OF RESEARCH/PARTNER

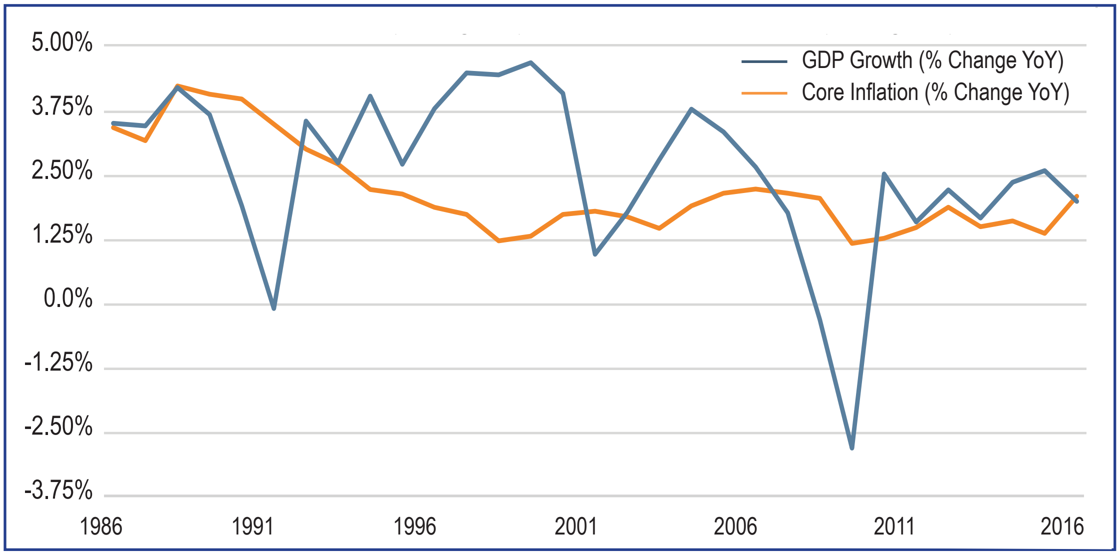
Donald Trump's victory and his subsequent tweets announcing fiscal policy initiatives dominated the fourth quarter. The Standard and Poor's 500 had posted modest gains for the year heading into the election. However, from November 8th through the close of the year, the market tacked on over 5%, bringing the year's total return to 12%. Not bad reflecting back to mid-February when the market was down over 10%.

President Trump's platform of fiscal stimulus has resonated with equity investors. More spending, lower tax rates, and fewer regulations are a stark contrast to the restrictive policies in place since the financial crisis. With a Republican-controlled Congress, many of the financial goals should be attainable. Early Cabinet appointees, which have included many experts from the corporate world, are proof that Mr. Trump is quite serious about achieving his goals.

The Federal Reserve has stated on many occasions that monetary policy alone wasn't enough to revive the economy. The Fed encouraged greater fiscal action by lawmakers. Mr. Trump has delivered. The Fed's response to more robust economic growth could be the difference between success and failure. Although the Fed did increase the Federal Funds rate by 0.25% in December, the rate hike is just the second in the past eight years. Interest rates remain low, reflecting anemic economic growth and inflation levels running consistently below the 2% target. Letting inflation run hot for a period may allow the economy to build momentum to withstand higher interest rates.

Future market returns will depend on two key variables. First, what incremental growth will be provided by the new policies? Second, how and when will the Federal Reserve respond to stronger growth and higher inflation? Before answering these important questions, we must first understand the limitations of lower tax revenue and greater spending. The U.S. national debt now stands at roughly $20 trillion, or 106% of gross national product. The debt/GDP ratio is at record levels (discounting periods of war). Entitlement programs, Medicare/Medicaid and Social Security, combined with defense spending, account for approximately 78% of total spending, leaving little room for financial maneuvering. Various sources have estimated that the fiscal policy could add anywhere between 0.25% and 1.8% to economic growth. While the improvement would be welcomed, the estimates fall short of the 4%

U.S. Core Inflation vs. Real GDP Growth



Source: FactSet

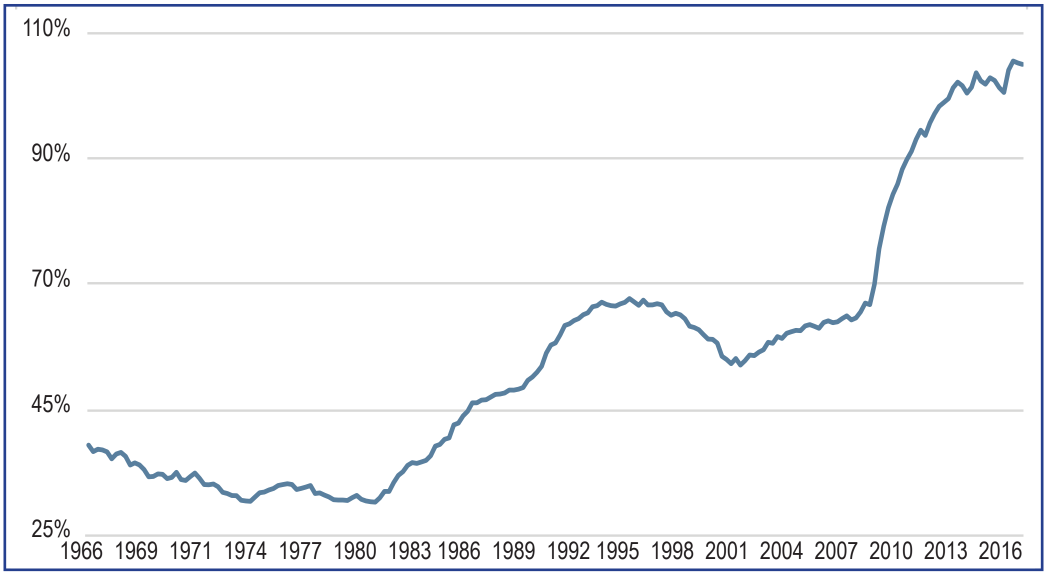
economic growth trumpeted by Mr. Trump. The U.S. has not posted a 4% annual GDP growth since 1999. However, just reaching 3% growth could provide the perfect blend of growth. This rate would likely not ignite inflation and would thus avoid the commensurate response of higher interest rates.

Interest rates have also had a dramatic move since the election. The rate on the 10-year U.S. Treasury moved from 1.78% prior to the election to 2.48% by year-end. Higher rates reflect expectations for better economic growth and the need for the Treasury to issue more debt to finance anticipated spending. Interest rates on one-month to five-year Treasury issues are at multi-year highs in anticipation of further Fed tightening. Municipal bonds did not fare well in the quarter as the prospect for lower individual tax rates reduces the appeal of tax-exempt income. Higher interest rates will come as a relief to investors who have watched yields continuously fall from the peak reached in 1981.

An improving economy coupled with an accommodative Fed can provide a powerful environment for the equity markets. Soaring consumer confidence adds a strong third rail. However, there are two potential hurdles in this rosy scenario. The first is the uncertainty surrounding U.S. trade policy. Mr. Trump has talked tough on trade, continuing his campaign theme of staunching the exodus of U.S. jobs. Intervention in current trade pacts, regardless of whether they are free or fair, may lead to retaliatory actions. Trade restrictions or other protectionist measures would have a profound impact on the economy and the fortunes of many multi-national companies. Second, the continuing strength of the U.S. Dollar presents challenges to corporate profits. Revenue and profit generated overseas is translated from foreign currency to U.S. Dollars for financial statements. Weak foreign currencies lead to fewer U.S. Dollars being reported and a possible reduction in earnings. The Mexican Peso, Canadian Dollar, Chinese Yuan, Japanese Yen, British Pound, and the Euro are all trading at multi-year lows versus the U.S. Dollar.

As we begin the New Year, we are confronted with risk and uncertainty. The strong post-election response of the stock and bond markets has quickly discounted the potential positive results of policies that aren't even in place. However, risk and uncertainty present opportunity. We will continue to maintain our value discipline in identifying high quality investments that, in our opinion, are trading at temporarily depressed levels. We appreciate your support and confidence as we remain focused and dedicated to achieving favorable results, regardless of the market environment. ■

U.S. Debt as a Percentage of U.S. GDP



Source: FactSet

Have You Heard About the New Fiduciary Rule?

NEILL PECK
MARKETING ASSOCIATE

In 2016, the Department of Labor finalized its rule expanding its definition of "investment advice fiduciary." The new rule, which is applicable as of April 10th, is meant to force financial advisors and brokers to give advice that is in clients' best interests - not their own.

Believe it or not, until now, anyone giving advice (like stockbrokers or insurance salespeople) only had to meet a "suitability standard." This low bar meant that whatever option the advisor recommended only had to be a "reasonable" option for the client. In practice, this meant that the advisor could recommend a high-fee fund (with a nice kickback to the advisor, of course) instead of a low-fee fund. The scale of the problem is significant: The White House Council of Economic Advisors estimates that these conflicts of interest lead to $17 billion in lost retirement savings every year.

The new rule greatly expands the circumstances that call for an advisor to meet a fiduciary standard. The concept of "fiduciary" has a specific legal definition that a given advisor can't get around, and it is the highest standard of care. There is extensive case history in which courts have imposed separately-defined duties of Care, Loyalty, Good Faith, Confidentiality, Prudence, and Disclosure upon fiduciaries[1]. A client whose advisor meets a fiduciary standard knows that they are in good hands. The new rule can't eliminate all bad investment advice, of course. Advisors can be careful, loyal, and honest and still be wrong. And there are still some small holes by which bad advice can be disseminated. But overall, this is definitely a step in the right direction for the industry.

The new rule might seem like a no-brainer, but it has been met with criticism from some parts of the financial industry. Predictably, the critics of the rule are those who benefit financially from the ability to receive kickbacks from 12b-1 and other fees from fund management companies. Also, there are many in the insurance business who push expensive annuity products that pay high commissions but aren't necessarily in their clients' best interests. To be frank, a good number of people saving for retirement have been paying too much for bad advice.

On the other side of this rule are Registered Investment Advisors (RIAs), who have always acted as legal fiduciaries. Tufton Capital falls into this category. As an RIA, our firm is not affected by the rule change. Our structure by its very nature puts our clients' interests ahead of our own. Unlike the salesmen in our business who parade as "financial advisors," our firm has no motive to recommend one investment product over another - other than its suitability for the client. Nor do we gain any benefit from extra or excessive trading in our clients' accounts. Here at Tufton, our primary focus and only incentive is to grow our clients' assets by following our investment process.

Some expect that Donald Trump will undo the new D.O.L. rule. For our firm, though, it won't matter: we always have and always will put the client first. ■

1 www.law.cornell.edu/wex/fiduciary_duty

Company Spotlight: VF Corp. (Ticker: VFC)

J. SCOTT MURPHY
PORTFOLIO MANAGER/PARTNER

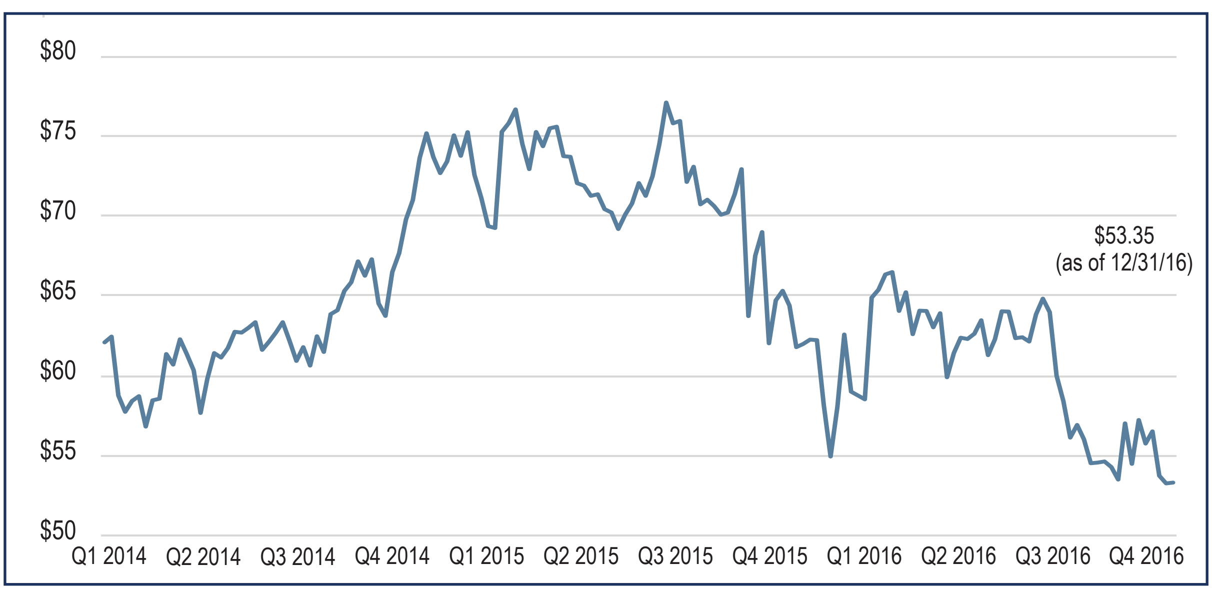
VF Corp. (Ticker: VFC) is one of the largest apparel and footwear companies in the world. VF has a diverse portfolio of brands, including five with revenue exceeding $1 billion: The North Face, Vans, Timberland, Wrangler, and Lee.

The stock has underperformed the market by (16%) in 2015 and (24%) in 2016. This 40% relative underperformance to the S&P 500 should prove to be a nice entry point. It seems Wall Street is questioning VFC's ability to maintain its prior growth. Other issues potentially causing a drag on the stock include a strong dollar, which has impacted earnings growth over the past few years, and some downgrades by Wall Street analysts.

VF Corp is a pioneer in inventory management, enabling them to partner with their customers (retail stores) to effectively and efficiently get the right assortment of products that matches consumer demand in a real-time environment. Retailers value this "just in time" inventory replenishment system since it allows them to minimize inventory costs. Internally, VF is organized into four segments: Outdoor and Action Sports, Jeanswear, Imagewear, and Sportswear/Contemporary Brands. VF derives approximately 70% of revenues from the Americas, 20% from Europe and 10% from its Asia Pacific business.

Steven Rendle will become the new CEO in the first quarter of 2017. He is currently the President of VF and his tenure with the company began when VF purchased The North Face in 2000. This was a planned transition and he is succeeding current CEO, Eric Wiseman, who will continue as the Chairman of the Board. With an improvement in earnings slated for next year due to better internal performance coupled with a reinvigorated consumer, the stock is ripe for a recovery in 2017. ■

VF Corp. (Ticker:VFC) Stock Chart



Source: FactSet

Inside the Investor's Mind

Emotions substantially affect rational thinking; when you let certain emotions fuel your investment decisions, your portfolio could be in trouble. Understanding the psychological weaknesses that typically afflict investors will help you prevent them from damaging your own investment portfolio.

What's Your Risk Tolerance?

Before identifying the emotions that typically affect investors, it's first important to understand risk tolerance. Risk tolerance is how much unpredictability a person can financially—and especially "mentally"—handle in his or her investment portfolio.

Those with high risk tolerance—meaning they're comfortable with investing in riskier markets—usually reap the highest long-term gains. But their chances of suffering short-term losses is just as high. Especially for retirement investments, investors in their 20s usually have a higher risk tolerance than investors in their 60s who are nearing retirement. Aging investors usually have a low risk tolerance; a short-term loss could deplete their portfolio and they don't have time on their side to recoup what they've lost.

Risk tolerance and emotions go hand in hand; successful investors know their risk tolerance and how certain emotions can either increase or decrease the amount of risk they take.

Emotions That Affect Investors

Emotions are the part of your psyche that influences your motivation and behavioral tendencies. In any area of our lives, when emotions run high, it causes our rational, commonsense brains to shut down and prevents us from making rational decisions. Euphoria, greed, fear and regret are just a few of the emotions that affect investors and the decisions they make for their portfolios.

Euphoria, optimism and overconfidence

Euphoria—the state of intense happiness and self-confidence—gives an investor that surge of adrenaline. Euphoria causes investors to be more optimistic about the stock market and certain stock picks. But the elation and pride from a gain can also prevent the investor from detecting risks. As their self-confidence increases, investors tend to view themselves as more competent to choose the right stock picks than they really are. Many times, overconfidence leads to greed.

Greed

Greed is the excessive desire that alters investors' judgment, leading them to poor decisions and irrational actions. Most people want to make as much money as they can, in as little time and with as little effort as possible. Investors have the instinct to always try and get a little bit more; but this "get-rich-quick" mentality can cause a frenzy in their portfolios, not to mention, the overall stock market.

Greed is not an easy emotion to overcome, and it can be the foundation for reoccurring investment errors such as "following the herd" and jumping on the bandwagon of the latest investment fad, or hanging on to stocks too long.

Fear

On the opposite end of the spectrum from greed is fear, an emotion just as debilitating to both investors and potential investors. Fear is an instinctual reaction to what someone perceives as an anticipated or actual threat. It can cause investors to do any of the following:

- Sit on cash that should be invested
- Sell winning stocks too soon or enter and exit the stock market too soon
- Hold on to losing stocks too long or stay in the stock market too long

Some people believe the stock market is too risky. They would be unable to stomach the ups and downs of their investment losing and gaining money. These individuals feel more comfortable protecting their money somewhere with very little risk, such as a savings account. Little do they know that stockpiling their cash in a savings account is a risk, too. While their money is safe in the short term, it's not growing to meet the rate of inflation over time. Preparing for major life events, living expenses in retirement and major purchases, your money must grow to afford the higher price tag of these expenses in the future.

Those who actually do invest are also susceptible to fear. Paralyzed by the fear of making errors, some investors either sell winning stocks too soon or hold on to losing stock positions that should be sold out because they're afraid of losing money. Some studies show that the pain of losing a certain amount of money is actually greater than the pleasure derived from winning the same amount.

Regret

Who likes to admit they're wrong? No one. For investors, it's difficult to admit they're responsible for making poor decisions about stocks. The pain of regret can cause investors to hold on to losing stocks too long or sell winning stocks too soon. A loss of wealth can be so painful to your psyches that you want to make the pain go away quickly. Usually driven by fear, investors will make any decision possible—however irrational it may be—to avoid experiencing regret.

Put Your Emotions in Check

It's easier said than done, but keeping your emotions in check will lead to personal investment success. So how can you accomplish this?

Know you're in control. Only you can prevent your emotions from clouding your investment decisions. Understand that once the emotion is released, it's difficult to contain. Identify your emotions before you act on them, and take time to think things through before jumping on an investment decision.

Educate yourself. Understanding how the stock market works will decrease much of the fear and anxiety that comes with investing. Thoroughly research your investment and examine the history of the stocks you're interested in. Don't simply look at how a company is performing now; analyze the history of the stock's performance. When you finally decide to buy, select your investment based on facts, not on speculative forecasts or because everyone else is buying them.

Choose an asset allocation mix that's right for you. This means diversifying your portfolio and finding that balance between riskier and conservative investments. Some investors build their portfolios largely out of stocks in order to have the best chance of providing a high return. Other investors buy mostly bonds and cash equivalents; these are low risk, but the returns are also very small. To combat the risk of huge losses for both those with high and low risk tolerance, investors diversify their portfolios by spreading their assets among different types of investments to minimize loss. Diversification is a reliable method to decrease risk while still getting solid returns.

Think long term. Avoid watching the day-to-day peaks and plummets of your stock. This can stress you out. Instead, concentrate on the long-term performance of your entire portfolio.

Talk to Tufton Capital Management. We are here to discuss your personal financial goals and educate you on investment strategies to meet those goals. ■

The Next Digital Revolution?

JOHN KERNAN
RESEARCH ANALYST

We believe automation in factories, self-driving big rigs, self-driving cars, drones, automated warehouses, and countless more are going to reshape retail and the economy of this and every country in the world. This is a long-term view, but we believe it is not as long-term as one might think. The ripple effects will be profound. For example, the occupation of "truck driver" holds a plurality in every or almost every state in this country. Entire towns have sprung up and have economies based on truck stops (think Breezewood, PA). What's more, artificial intelligence has advanced to a point where the technologies that IBM and Google have right now would have been science fiction just a decade ago. We at Tufton Capital tend to believe that the pace of this change is going to take large swathes of the population by surprise (including the government).

However, the interplay and timing of these factors are impossible to predict. We have seen the rise of populism and a leader who may not consider the long-term economic consequences of legislation and executive orders. For instance, say that Amazon and Uber are successful in driving truck drivers out of the supply chain. There are an estimated 3.5 million professional truck drivers in the country, and 8.7 million employed in the trucking industry. Suddenly we would have millions of former truck drivers who focus their blame on Amazon for "taking their jobs." Amazon might be broken up, or a restriction or onerous tax on self-driving technologies could be levied. None of this would ultimately prevent the march of technology, of course, but it would be very bad for Amazon, or whatever player finds itself at the receiving end of displaced workers' ire.

We are not saying any of the above will happen to Amazon or Uber. In fact, those two companies have teams of the brightest innovators in their respective spaces (the other standout being Google). But these are examples of what could happen to any given company.

As it is right now, we can't say who the winners and losers will be. In Tech, it seems that any company that has any modicum of proven "cloud" or "hyperscale data technology" gets immediately launched into the stratosphere of valuation by West Coast investors who also see these trends coming.

Our last caveat is timing. We are confident these changes are coming, but do not know when they will take hold.

A final macroeconomic point is that the Roald Dahl-inspired idea that these workers can "get new jobs programming the trucks" is misguided. First, it will take only a handful of programmers to maintain the code on an entire fleet of trucks. Second, those who are losing the trucking jobs are far from qualified to transition into advanced computer science applications. This shift in job requirements will create a massive amount of friction in the labor market, and unemployment will be inevitable.

So, what is the investment strategy? A general overweighting in the Tech sector might be warranted, but even something as broad as that would be exposed to political moves. We expect the digital revolution to be bumpy. ■

TUFTON CAPITAL MANAGEMENT
303 International Circle, Suite 430
Hunt Valley, Maryland 21030