TUFTON CAPITAL

MANAGEMENT

Viewpoint

SUMMER 2017

With the fireworks long faded, and the bunting stowed away, the high holiday of summer has come and gone. But if the party is over, a question now looms large. Who's going to tell that to the American stock market?

For all the talk of stormy seas that preceded it, the story of 2017 has turned out to be one of decidedly smooth sailing. In the first six months of the year, both the Dow Jones Industrial Average and the S&P 500 rose by 9%, more than doubling their gains over the same period last year. Over on the NASDAQ, where high-technology (and high-publicity) business models reign supreme, the good fortune rolled in even faster. Up 15% since the year began, the index is on track to turn in its best year in nearly a decade. A few weeks back, while all three indices breached or skirted all-time highs, the VIX—which measures fear in the market—approached a 20-year low. Just like those 4th of July fireworks, the year has certainly begun with a "bang."

In frothy times like these, you may notice that the notion of all investments being good investments tends to gain traction. As the saying goes: "A rising tide lifts all boats." And yet, digging into the data, we find that the case for careful asset selection—as opposed to "spraying and praying"—remains more compelling than ever. This is evident in a survey of the season's IPO schedule, in which hotly-anticipated offerings such as Snapchat and Blue Apron proved better at selling newspapers than rewarding shareholders.

Perhaps more important, this is evident in the market's success stories. Consider, for instance, the aforementioned S&P 500. Of the 500 stocks tracked in the flagship index, a mere twenty-five accounted for nearly two-thirds of this past quarter's gains—or, put simply, a minority of stocks created the majority of returns. To your dedicated team of investment professionals, this phenomenon is a stark reminder that even when "all boats" are rising, some certainly rise higher than others. This is why, even as we happily report that many of those top twenty-five companies are Tufton holdings, we remain hard at work on your behalf, in diligent search of the horses that will pull next quarter's cart.

In the pages ahead, you'll find an overview of one company that we believe fits that bill, along with some of our most current market insights. In an effort to more deeply articulate the thinking behind those insights, we've also included a brief "spotlight" piece on Benjamin Graham, a pioneer of value investing and role model to more than a few members of your investment team. It's our hope that you'll read them at your leisure, and give us a call should anything catch your eye. Because no matter where the summer takes you—and we do hope it's somewhere relaxing—you can rest assured that we'll be here, carefully guarding the trust you've placed in us. ■

Chad Meyer, CFA
President

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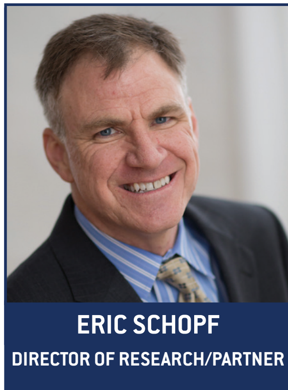
The Second Quarter Of 2017: Steady As She Goes



ERIC SCHOPF
DIRECTOR OF RESEARCH/PARTNER

The stock market continued to march higher in the second quarter. A solid 4% total return in the second quarter of the year brings performance for the first half of 2017 to around 9%. On June 19, the Standard & Poor's 500 reached an all-time high of 2,453. The Dow Jones Industrial Average and the NASDAQ markets also hit record highs during the quarter. This strong performance has been accompanied by very low volatility. For example, the stock market fell for three consecutive days just twice during the quarter. Another positive mark was that the largest one-day drop in the S&P 500 during the quarter was 1.82% on May 17, which more than recovered in the five trading days that followed. The lack of volatility in the stock market reflects the placid, stable U.S. economy. This year will mark the eighth consecutive year of economic growth falling in a tight range of 1.5% - 2.5%.

On the other side of the fence, the bond market marched to the beat of a different drum during the quarter. Short-term interest rates moved higher in reaction to Federal Reserve policy, but intermediate- and long-term rates moved significantly lower. The yield on 10-year U.S. Treasuries touched 2.14%, approaching levels that prevailed in December 2015, prior to the start of the Fed's tightening cycle. Lower long-term rates cast doubt over anticipated future economic growth and the inflationary pressures that typically accompany such growth.

The mixed signals provided by the bond and stock markets will eventually be reconciled. The stock market cannot continue to move higher if the economy falters. Conversely, interest rates cannot continue to move lower if the economy continues to deliver solid growth. This disconnect will be resolved by the Federal Reserve. The Fed raised the Federal Funds Rate by 0.25% in June. This rate increase was the second this year and the fourth so far in the cycle. The lower rates in the bond market suggest that higher interest rates could slow an economy that is already weak by historical standards. Since many commercial and personal loans are adjustable in structure and tied to short-term interest rate benchmarks, further interest rate increases will begin to bite businesses and consumers. The stock market's performance implies a continued soft touch by the Fed and perhaps questions the need to raise rates in the first place. Inflation continues to trend below the Fed's 2% target rate, and projections for GDP growth have been tempered.

The Fed continues to garner attention as they prepare to normalize their balance sheet. The Fed holds $4.2 trillion in U.S. Treasuries and mortgage-backed securities. The assets were accumulated to push longer-term interest rates lower in an effort to stimulate the economy following the financial crisis. The plan is to let securities mature and cap reinvestment of the proceeds, thereby reducing assets held. The unwinding of the balance sheet, combined with increases in the Federal Funds Rate, should lead to higher interest rates across the yield curve.

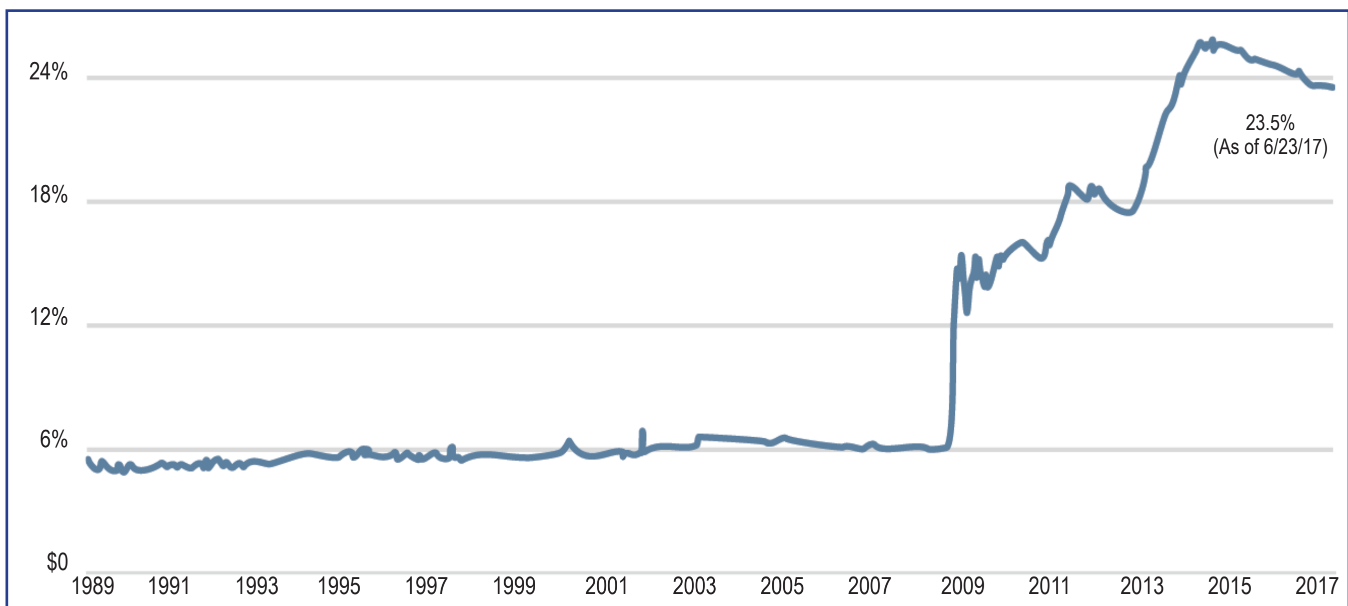
The Fed would like to engineer a soft landing – slowing the economy just enough to curb any inflationary pressure but stopping short of throwing the economy into recession. Unfortunately, the Fed has a poor track record here. They are 1 for 16, with their lone victory coming in 1994. That is fifteen recessions in sixteen attempts. This abysmal batting average is exactly why we spend so much time scrutinizing the Fed and providing updates on their activity.

The activity in Washington, or lack thereof, is also very important. The healthcare reform effort is collapsing under the weight of disparate interest groups. The outcome of any reform impacts health insurers, states, hospitals, healthcare providers, real estate owners, pharmaceutical manufacturers and medical device manufacturers. However, the greatest impact may be on tax reform. Repealing and replacing the Affordable Care Act was projected to reduce taxes by $1 trillion.

The tax reductions combined with cuts in Medicaid spending were projected to be budget neutral. Keeping the status quo on healthcare will necessitate the need to look elsewhere if any meaningful tax reform is possible.

One area of great activity has been on the regulatory front. Following the Financial Crisis, financial regulations formulated and applied under Dodd-Frank Wall Street Reform and Consumer Protection Act helped purge the system of dangerous practices and forced institutions to rebuild capital bases. Now that most financial institutions are on solid ground, many tentacles of the Act are being modified. The release of the latest Federal Reserve stress test confirms that the time is right for change. All 34 participating bank holding companies passed the test on the first try. The stress test assumed a severely adverse scenario, where unemployment rose to 10%, and there was heightened stress in corporate loan markets and commercial real estate. According to the Federal Reserve, the firms' Tier 1 capital ratio (which compares high-quality capital to risk-weighted assets) would fall from 12.5% in the fourth quarter of 2016 to 9.2% in the hypothetical stress scenario. The Tier 1 capital level following the adverse scenario would actually be higher than the Tier 1 capital level prior to the financial crisis. Since 2009, the 34 firms have added more than $750 billion in common equity capital. Decreased regulatory burdens will increase the capacity of banks to lend money and pay higher dividends which is a sure positive for the economy.

The outlook going forward continues to be positive. Steady growth, low inflation, and employment gains provide a favorable setting. However, the Federal Reserve has taken additional steps that may disrupt the outlook. Eventually, they will go too far and will tip the apple cart. Until then, steady as she goes. As always, we will continue to monitor the situation and invest to profit and preserve. ■



Source: FactSet

Diversification: Investing's "Free Lunch"

JOHN KERNAN
RESEARCH ANALYST

Diversifying a portfolio is a relatively simple concept. If you have more securities and one goes bad, it won't sink your whole ship. Diversification is often called investing's "free lunch" for good reason. You get the benefit of lower risk with little extra cost to you as the investor.

Proper diversification isn't always as straightforward, and investors can get themselves into a mess while thinking they're doing the right thing by holding lots of funds. For example, any investor choosing a mix of assets has certainly heard of diversification, but while looking at a menu of 50+ mutual funds, how to diversify might not be so clear. He or she might "wisely" choose several funds that look to be different. Looking at Vanguard's "Stock Funds" menu, it would be easy to pick the following list of funds:

- U.S. Growth
- U.S. Value
- FTSE Social Index
- Mid-Cap Strategic Equity
- Strategic Small-Cap Equity

Once we choose, how much money goes in each fund? The answer isn't obvious, so investors often just split them up evenly[1]. Let's take a look at some problems with the resultant portfolio:

Overdiversification

This is the biggest and maybe most common issue. This portfolio holds 947 stocks. Plus, we often find the same stock in many of the funds. Sure, **Apple** is a common holding because it's so large, but four out of five of these funds holds **Quintiles IMS Holdings Inc.** – not exactly a household name. What's the value of holding 1000 stocks in five different funds? Does it justify paying extra fees, or are you just indexing? These questions lead us to our next problem, which is "diworsification."

Diworsification

A subtle facet of overdiversification is the fact of "diworsification," where adding more correlated assets just moves an investor closer to the index without adding any risk reducing benefit. To reduce risk, assets must be at least partially uncorrelated. Some event that causes one stock to go down won't necessarily cause another stock in the portfolio to do so. For example, a crash in Americans' appetite for chocolate won't make

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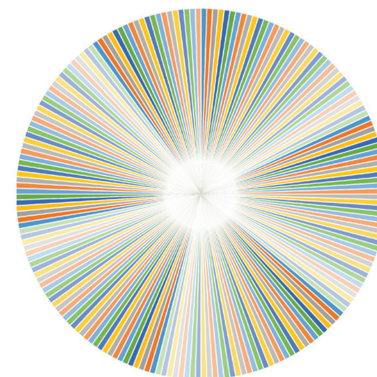
A Reasonably Diversified Portfolio

Plenty of holdings to spread the risk, but large enough positions where the winners will boost performance.

A Multi-Mutual Fund Portfolio



Individual holdings get lost in this portfolio, and even a great stock pick will be too small to boost performance.

1. An approach called "1/N diversification."

Company Spotlight: Bristol-Myers Squibb (Ticker: BMY)

Barbara Rishel
PORTFOLIO MANAGER

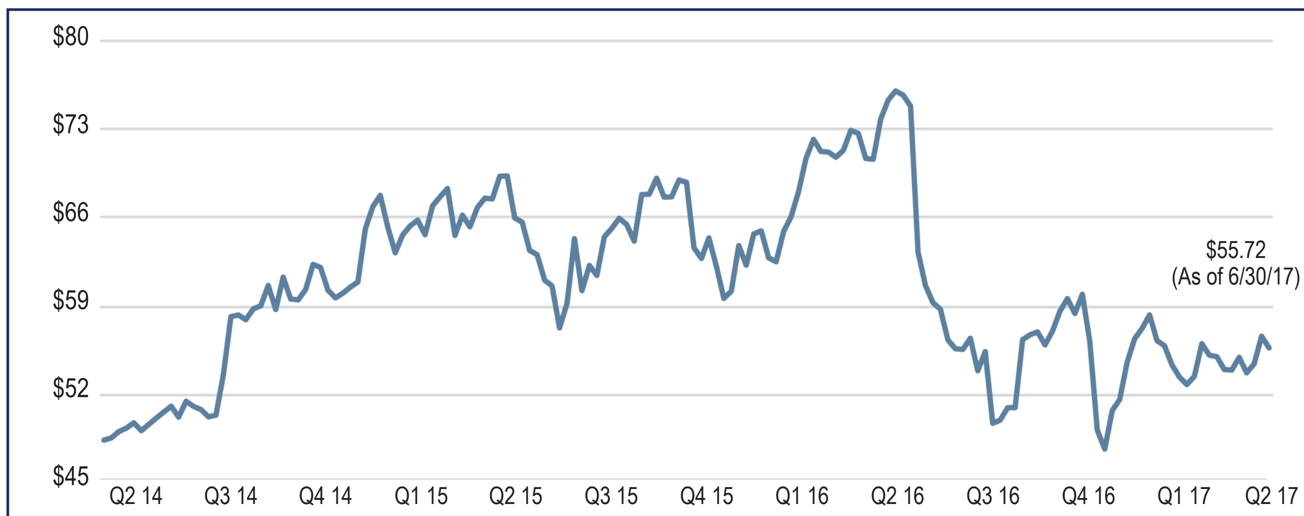
Bristol-Myers Squibb (Ticker: BMY) is a leading biopharmaceutical company that discovers, develops, manufactures, and distributes products worldwide. Squibb was founded in 1858 and Bristol-Myers Corporation was founded in 1887, and the two came together a hundred years later in 1989 to form BMY. Today, the company generates annual revenues of $20 billion.

BMY's product line serves several important therapeutic areas, but most important to Bristol is its oncology business. Within oncology, investors' hopes focus on Bristol's drug Nivolumab, marketed as Opdivo. Opdivo works as a checkpoint inhibitor, using the patient's own immune system to combat cancer. Immune checkpoint science has been progressing in the fight against cancer for almost twenty years, but Opdivo only received FDA approval for the treatment of melanoma in 2014, making it a cutting-edge treatment. The drug is undergoing further testing in combination with other drugs to improve outcomes and expand the addressable market.

Investing in the pharmaceutical industry is high risk/high reward. The cost to develop pharmaceutical drugs is very high and carries no guarantee of success. Although patent laws provide product protection against uses of the same drug, competitors are constantly in the lab working on new, better (or even just different) treatments. While success may bring impressive profits, it also invites scrutiny from those organizations working to drive down the cost of healthcare. Bristol-Myers Squibb is an example of the risks facing pharmaceutical companies. BMY enjoyed great success in the 1990's due in large part to their blood thinner Plavix. The eventual loss of patent protection and the lack of a new product pipeline resulted in the stock losing over 70% of its value in 2001 and 2002. The company began rebuilding and made a big commitment to the oncology market.

Opdivo shows great promise but is not without risk. Although BMY enjoyed a first-mover advantage, a series of clinical setbacks has allowed competitors to emerge. As a result, the stock has declined 25% over the past year. We believe the current price represents a good value given the potential for further development and success in the oncology field. ■

Bristol-Myers Squibb (Ticker: BMY) Stock Chart



Source: FactSet

Great Investors: Benjamin Graham

In a marketplace that frets constantly over what comes next, we believe it is equally instructive to consider what came before. In this investor spotlight, we examine the work of Benjamin Graham, whose contributions to the field of value investing guide our process here at Tufton Capital.

If anyone could be considered the father of modern stock analysis, it would be Ben Graham. During the '30s, '40s and '50s, Graham pioneered the ideas of "value investing" and taught the next generation of investors to see the difference between stock evaluation and market speculation.

Ben Graham was born Benjamin Grossbaum in 1894. He was born in England, but his family emigrated to the United States when he was only a year old. His parents ran a reasonably successful importing business until his father died in 1903, at which point the business deteriorated. Ben was forced to begin working while still in school.

Like many great investors, Graham was a brilliant student. He graduated at the top of his class at Columbia University, and at age 20 he was offered teaching positions in three different departments at the college. Graham turned down the offers and went to look for work on Wall Street.

Graham quickly found a job as an assistant at the brokerage firm Newburger, Henderson & Loeb. His initial job was writing descriptions of the bonds that brokers would be recommending to clients. The company recognized Graham's skill, and after a few weeks they let him write the recommendations by himself.

Graham's role in the company changed several times within his first year, but he finally found his niche as a securities analyst. During his time at Newburger, he successfully detected a number of mispriced assets and trade opportunities. His analyses helped the brokerage make solid profits, and eventually led to Graham becoming a full partner in 1920. He was just 26 years old.

A few years later in 1923, Graham left Newburger to help create the firm Graham Corp. He met with great success, but had to shut down the corporation after two years due to failed profit negotiations with one of his major investors. The next year, he created a new investment company with fellow broker Jerome Newman. The company was wildly successful, and effectively raised his clients' initial investments by 400% in just three years.

Despite his skill, Graham could not escape the effects of the 1929 and 1931 market crashes. Though he had a strategy to deal with a declining market, his tactics were overwhelmed by a market where no one wanted to buy. Graham managed to survive the crashes, however, and soon was back at work making successful investments.

By the late '30s, the partnership between Graham and Newman evolved into the Graham-Newman Corporation. It was one of the most successful on Wall Street, making average annual returns above 15%. Graham remained an active investment manager with the corporation until his retirement from trading in 1956.

Far more important than his success on Wall Street, Graham's legacy lives in the knowledge he passed on to others. In 1928, a year before the crash, Graham accepted a teaching position at Columbia University. There, he taught students how to analyze stocks carefully and rationally, and helped them to distinguish between "investing" and "speculating." As Graham's personal success continued to increase, he found more and more students lining up to learn his approach to stock analysis and investing.

Graham's lessons are still a foundational part of modern investing, but his teaching career is possibly best known for the students it produced. Warren Buffett, Walter Schloss and David Dodd are among the most famous students Graham taught at Columbia. Their successes have inspired a new generation of investors and have created a continual public interest in Graham's theories.

The epitome of Graham's teachings lives on in his two popular books *Security Analysis* (1932) and *The Intelligent Investor* (1949), both of which are still in print today.

Graham's first book, *Security Analysis*, is a technical description of the stock evaluation process and the trademarks of a quality stock. It was written with his former student, David Dodd, and is considered the primary book on value investing.

In *The Intelligent Investor*, Graham outlined the principles of sound thinking within investing. The book is aimed at both amateur and professional investors. It describes the mindset value investors need to keep when purchasing and holding stocks. *The Intelligent Investor* is considered a foundational piece of financial education and is Warren Buffett's favorite book on investing.

Though Graham was a man of huge successes, his personal life was less celebrated. He was divorced three times and has been referred to by some as a womanizer. His first divorce (in the '30s) was more damaging to his family than to him, leaving a mark on the social reputation of his wife and children. Graham died in 1976 in his house in France where he lived half of the year with his mistress.

On Investing

"Operations for profit should be based not on optimism but on arithmetic."

Graham is possibly the most academically-minded investor of all time. He not only took a purely mathematical approach to investing but also used his knowledge to improve his principles and formulas to educate future investors.

"The underlying principles of sound investment should not alter from decade to decade, but the application of these principles must be adapted to significant changes in the financial mechanisms and climate."

The heart of Graham's strategy was value. He did not purchase shares assuming a company would have success with a new product or venture. Instead, he found companies that already had solid book values but were selling below their logical prices. He spurned the idea of buying trendy or on-the-rise stocks and believed most investors were just speculators.

"Basically, price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal."

Graham's principles would have no credibility if they had not proven so effective. His concept of a close analysis of a company's books proved to be extremely useful in an age when few others were doing the same. On one occasion, Graham's analysis found that the Northern Pipeline Company was trading for $65 a share when it had railroad bond assets worth $95 a share. He purchased a large number of shares and convinced the company to sell the assets, resulting in a $70 dividend. Graham walked away with a huge profit, simply because he was willing to look at the fundamentals of a company.

Most businesses change in character and quality over the years, sometimes for the better, but perhaps more often for the worse. The retail investor need not watch his companies' performance like a hawk, but he should give it a good, hard look from time to time.

The only problem with Graham's investment approach is that it will never allow modern investors to be as successful as he was. The market has become much more efficient since the early 20th century. Scores of professional analysts with access to incredible amounts of data have left no obvious investments unchecked. Still, investors can find value stocks wherever a good company is ignored for being "boring" or temporarily unsuccessful. Just as speculation makes some stocks needlessly expensive, it makes others unexpectedly cheap.

To achieve satisfactory investment results is easier than most people realize; to achieve superior results is

(Continued on page 8.)

(Diversification... Continued from page 4.)

a Japanese confectioner's stock go down as much. This relates to our next problem.

Geographic Concentration

U.S. investors want to buy what they know, and the vast majority of Americans have overweight positions in U.S. companies. It makes some sense, especially given the trouble that other economies have had in the last decade. But history tells us that the U.S.' relative performance won't last forever, and there are plenty of investment opportunities abroad that have low correlations with U.S. assets – just the protection we are looking for.

Asset Allocation

Finding the right mix of stocks, bonds, and other assets is a challenge, to say the least. Our theoretical investor didn't think about what happens if the stock market tanks starting tomorrow. Can he afford the ten or so years to make up that loss before retirement? ■

(Ben Graham... Continued from page 7.)

harder than it looks.

Philanthropy

Though he did not create private foundations nor publicize charitable donations, Graham was a very generous man. He often did expensive favors for his friends and always made enough time for those who wanted to talk. Most shockingly, he would give out stock advice to individuals, telling them the companies he intended to invest in, which allowed them to get in on a good buy without investing with his company.

Probably the most philanthropic act Graham undertook was publishing his books. In his writings, he outlined the strategies investors could use to make money in the same way he did. Graham owed much of his success to being different from other investors. Yet, he felt so compelled to teach others; he willingly gave away secrets and damaged his own ability to make profits for himself. ■

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