TUFTON CAPITAL
MANAGEMENT

VIEWPOINT

FALL 2017

As the temperature finally drops, the landscape subtly shifts, and children everywhere resignedly dig out their real shoes and dust off their school uniforms, it's difficult not to take pleasure in the perennial change that autumn brings. As anyone who has watched more seasons pass than they care to admit knows, this brand of change—the predictable kind—doesn't really count as change at all. Instead, it represents a keeping of plans, and all the comforts that come with knowing the world is still spinning right on schedule.

Of course, in an autumn like this one, even the most optimistic among us could be forgiven for suspecting that there may be a different sort of change afoot—and that whatever "schedule" once reigned is now subject to revision with a few hours' notice. As a glance at the evening news suggests, our country is plainly on the brink of a dramatic and unpredictable change on multiple fronts. From the hurricanes rocking our nation's shores, to the political debates rocking our national dialogue, to the looming prospect of war with North Korea, stability appears to be a commodity that grows scarcer in America by the day.

Nor, it would seem, is the the financial sector bucking the trend. As hordes of market commentators (and, perhaps, your local cabbie) will eagerly attest, Bitcoin, Ethereum, and various other "crypto-currencies" may well be on the verge of sending dollar bills the way of the dodo bird. But even as the market's enthusiasm for digital currency renders it the hottest asset class of the year, all the fervor has some experts crying foul. Bitcoin "is a fraud," declared JPMorgan Chase CEO Jamie Dimon at a recent investor conference. "It's just not a real thing."

Finally, and perhaps most perplexingly, there's the stock market itself, humming along nicely as the world around it rattles and shakes. In the third quarter of 2017, the Dow Jones, S&P500, and NASDAQ all rose by roughly 4% or more, with the latter index posting gains of nearly 6%. That level of performance and the low volatility that attended to it have, in some circles, given rise to the anxiety that the market is "ignoring" broader macroeconomic trends. Doesn't the market see (so this brand of hand-wringing goes) all the change that's lurking about?

Put simply, it does, but it also recalls that it has seen all this before. For the last two hundred years, while America has faced conflicts and crises of every ilk, at home and abroad, the U.S. stock market has quietly chugged along as one of the most reliable wealth creation vehicles in the history of mankind. And at the risk of seeming old-fashioned, we here at Tufton Capital tend to believe it's going to keep chugging, no matter how the wind howls outside our door.

In a world that changes by the minute, we thank you for the opportunity to protect and grow your capital, and we remain honored by the trust you've placed in us. ■

Chad Meyer, CFA
President

Inside This Issue

The Third Quarter Of 2017: The Irrepressible Stock Market

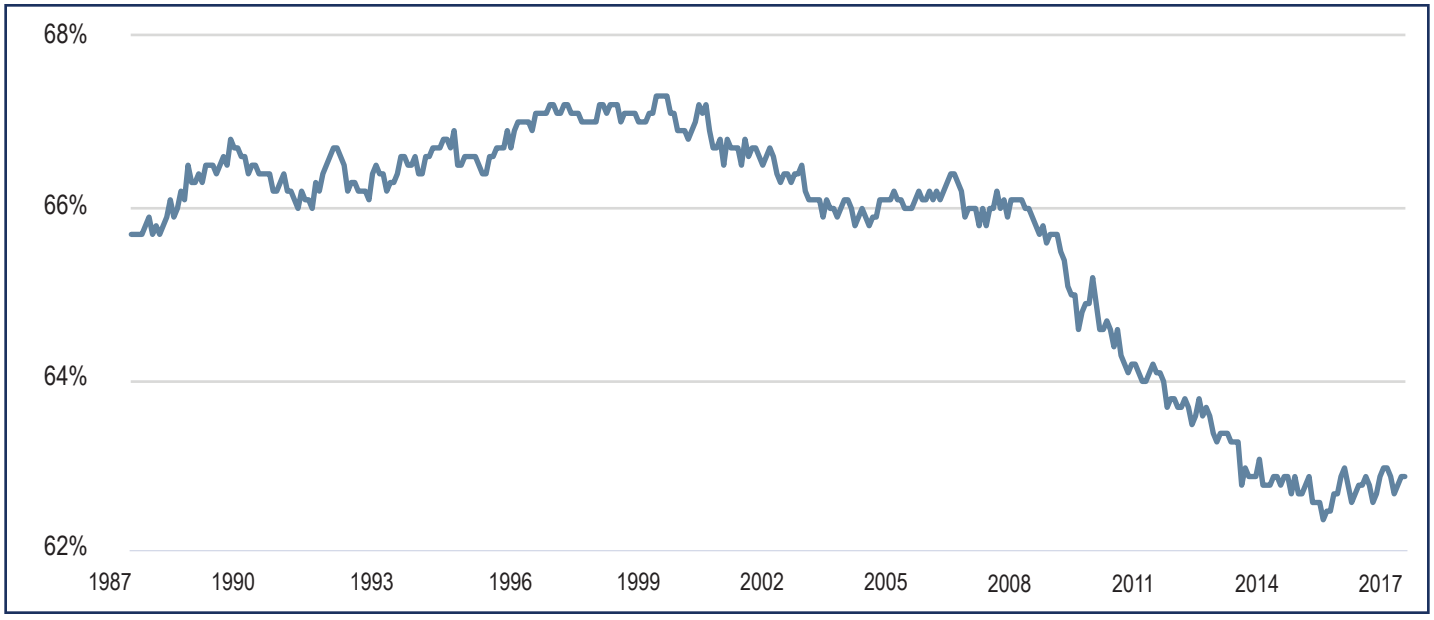
ERIC SCHOPF
DIRECTOR OF RESEARCH/PARTNER

The third quarter gave us yet another solid advance in the stock market. The Standard & Poor's 500 delivered a total return of 4.5%, and for the year in full, the broad-market benchmark has delivered 14.3%. Also keeping in line with the first half, the S&P saw little volatility in the quarter. Wanting to give us at least a little excitement, the bond market gyrated throughout the past three months. However, by September 29, intermediate- and long-term interest rates closed essentially unchanged from June 30. Short-term interest rates continued to move higher in reaction to Federal Reserve policy. And so, we march steadily upward.

The stock market's lack of volatility is truly remarkable given the wide range of social, geopolitical, and meteorological events that punctuated the quarter. The largest setbacks in the markets occurred in mid-August, when tensions with North Korea rose. Reports from the self-isolated nation revealed that it was examining an operational plan to strike areas around the United States' territory of Guam with medium-to-long range strategic ballistic missiles, enough to rattle any market participant. Then, a week later, it was rumored that Gary Kohn, the Director of the National Economic Council and a chief economic advisor to President Trump, was considering resignation after the President failed to blame neo-Nazis for the Charlottesville, VA violence. The resultant selloff was short-lived, though, and the stock market was within a few points of its all-time high by the end of the month. The Category 5 forces of Harvey, Irma, Jose, and Maria only fueled the market's advance. Investors looked past the short-term effects and saw that building reconstruction and automobile replacement will more than offset the temporary slowdown in economic activity.

Falling in line with the squadron of ho-hum, the interest rate backdrop changed little during the quarter. Rates remain at historically low levels. The Federal Reserve

U.S. Labor Force Participation Rate



did announce plans to begin winding down their $4.3 trillion bond portfolio by letting bonds mature without reinvestment. This development didn't raise rates, though, as the pace of contraction will initially be so slow as to be almost undetectable. Inflation is also keeping rates down below the Fed's 2% target, despite a low unemployment rate of 4.3%. Low unemployment rates belie the true state of the labor market, which is likely looser than we'd prefer, given the labor force participation rate.

Labor force participation, the ratio of payrolls to the working age population, is a clear indication that there is still slack in the work force (see chart). The broader deflationary themes of an aging population (and thus, work force), globalization, and technological innovation continue to play a significant role in the disinflationary environment. Low inflation undermines the Fed's case for interest rate hikes. Low interest rates in turn support higher stock valuations. Thus, we seem to be stuck with low inflation, low interest rates, and a richly-valued market.

We turn now from the "boring" market to the piece of modern America that seems more turbulent than it has ever been - politics. Washington's focus has now shifted from the Affordable Care Act to tax reform. Potential changes in the tax code have replaced the Fed as the primary influence on interest rates for the balance of the year. If these reforms were both successfully passed and meaningful, they would be a major catalyst for the equity and credit markets. The ultimate scope of reform will depend on Congress' ability to compromise on change, something that has been rare of late to say the least. The very idea of implementing a complex reform versus a simple tax cut gives some uncertainty to any such proposal. The more variables that are added to any plan, the less certain economic growth becomes. A tax reform cannot avoid adding many unknowns.

The current tax thinking goes like this. Seeking to reshape both tax structure and the U.S.' prosperity, the heart of reform lies in reducing corporate tax rates. Our statutory rate of 35% puts America at a competitive disadvantage with nearly all global peers. So, the plan is to reduce corporate rates to a level that makes it economically feasible to keep jobs at home. These additional jobs would lead to a greater collection of personal income taxes. If the Administration's math is to be believed, the larger take on personal income taxes will largely offset the loss of corporate taxes. Thus, a balance is achieved, and everyone is happy.

However, there is also discussion of lowering taxes on individuals. Lowering personal taxes strains the Administration's math, which to begin with is somewhat tenuous. Many experts do not think that the taxes from the higher spending that are supposed to come on the back of greater growth will compensate for the proposed cuts in tax rates. To help bring taxation and spending more into line, the elimination or reduction of tax deductions will be required. This is the part that requires compromise and is so difficult, since no taxpayers want to give up their deductions. Furthermore, reductions in Federal spending have been absent from the conversation.

We have no doubt that the economy could benefit, at least in some small measure, from changes in the tax code or a tax cut. There is little room for error though. Should tax reform not generate the desired growth, the national debt will balloon (see chart). A greater national debt at a time when the Federal Reserve is reducing their net holdings of Treasury securities will most likely push interest rates higher. The Fed

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Bulls Make Money, Bears Make Money, But Pigs Get Slaughtered

NEILL PECK
MARKETING ASSOCIATE

You may have heard this old Wall Street maxim that warns against greed and impatience, but have you followed it? Without a doubt, the stock market can be an exciting place, and it's easy to get roped into the allure of finding the next home run or timing a trade just right. For instance, a friend at a cocktail party may tell you about the killing he made off that ABC trade, and you may think, heck, why can't I do that? Then there's your inner trader who may get the best of you and get you thinking that you too can perfectly time your entry and exit points. If you have ever found yourself directing trades based on your emotions or you have attempted to time the market, are you really investing for the long haul? Or are you looking to make a quick buck? At Tufton, we may even suggest that you are gambling (not investing) with your retirement savings.

Research has shown that investors are significantly better off by following the approach of "time in the market" rather than timing the market. From 1998 until 2012, CXO Advisory Group ran a study to attempt to see if 28 self-described market timers could successfully time the market. The overall results were not good. They found that market experts accurately predicted the direction of the market only 48% of the time. Only 10 of the 28 experts could accurately forecast equity returns more than 50% of the time, and not even one could outperform the S&P 500. The evidence was so conclusive that CXO decided to stop tracking the statistics entirely! Unfortunately, sales skills triumph over investment skills on Wall Street from time to time, and often the loudest pundits get most of the attention. If an investment strategy sounds too good to be true, it is.

Another caveat to deter you from timing the market is that, over time, it's possible to underperform significantly by sitting on the sidelines. Yes, it can be very costly to sit in cash. For instance, if you examine the chart below, you see that if you missed the top 12 months in the past 5, 10, 25, and 50 years, you would have underperformed the S&P 500 significantly in each scenario.

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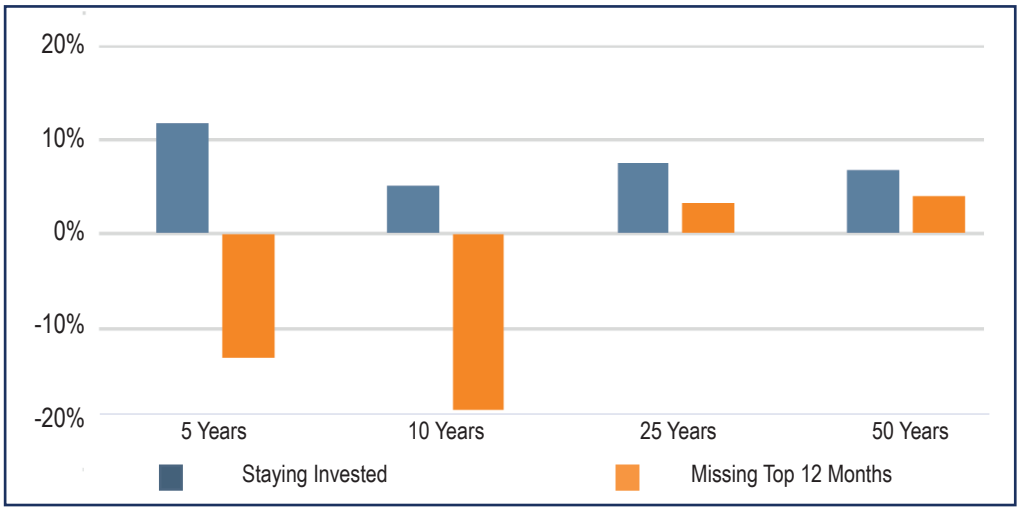
The Cost of Missing the Top 12 Months in a Given Period



Source: FactSet

Company Spotlight: TJX Companies, Inc. (Ticker: TJX)

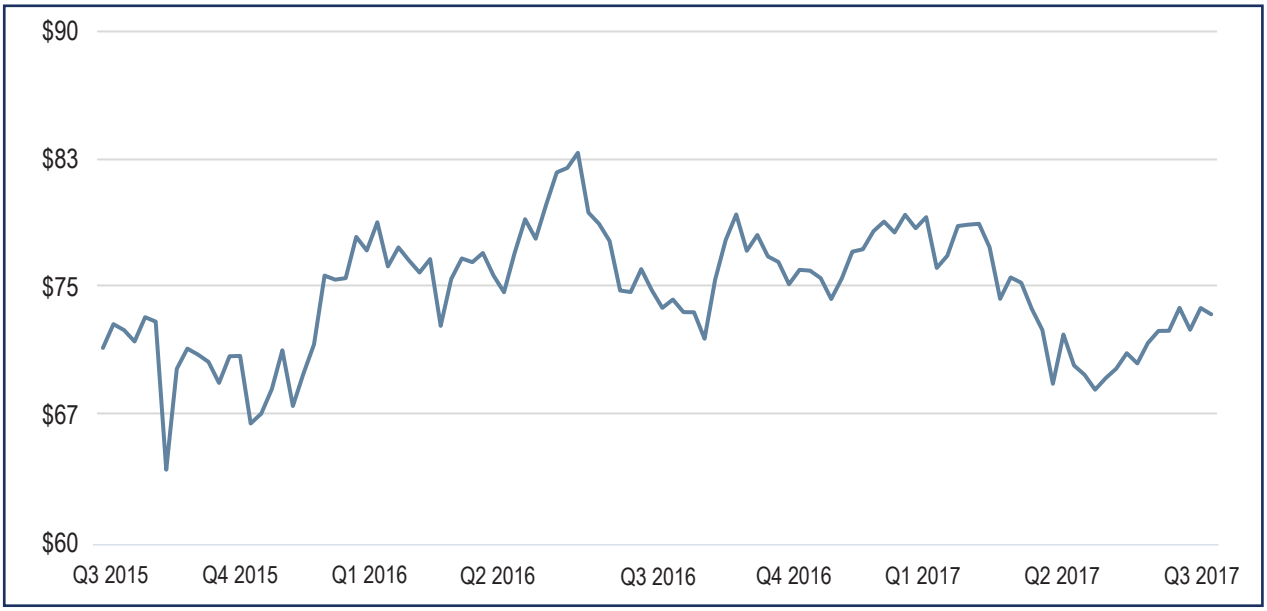
SCOTT MURPHY
PORTFOLIO MANAGER/PARTNER

While the overall stock market has been rewarding for most investors in 2017, the same cannot be said for the retail sector. Amazon has become a "legendary and mythical beast" of sorts and has become the biggest competitive threat for every retailer, placing the stocks of traditional brick-and-mortar retailers on the sale rack. As value investors, we readily acknowledge the magnitude of change in retail but still believe there is a place in our portfolios for a traditional retailer like TJX Companies, Inc. (TJX).

TJX has a leading market position in the off-price retail market. They control 45% of the discount retail market and operate 3,800 stores under the brands TJ Maxx, Marshalls, HomeGoods, and HomeSense. In a tough and changing retail environment, TJX has been able to grow its same store sales for twenty-one consecutive years. Simply put, they have proven they can grow sales and earnings through good and bad economic times. Many attribute this resilience to their customers' "treasure hunting" experience. At TJ Maxx, customers can arrive at the store not knowing exactly what they are looking for, and end up finding something they like at an irresistible price - a "treasure." This customer experience and incredibly low prices have largely allowed TJX to defend itself from the industry disruption caused by Amazon.

Therefore, we have begun to initiate positions in this well managed, industry leading discount retailer that has underperformed the market for two straight years. Our expectation is the market will realize they have misjudged the power of this off-price traditional retailer and will become buyers again, boosting the stock price in the process. ■

TJX Companies, Inc. (Ticker: TJX) Stock Chart



Source: FactSet

The High Stakes of Low Volatility

TED HART
RESEARCH ASSOCIATE

As mentioned in our lead article, the S&P 500 is up 14.3% this year through the third quarter. With that gain, the market has witnessed the second-longest period without a 3% pullback since 1928. If this streak continues through October, the S&P 500 will set the record for longest such period. On top of that, the average range between daily highs and lows on the index is also hitting historical bottoms. Investors are attributing this low volatility to a number of factors, some of which include passive and quantitative investing strategies. In fact, many of these approaches might be providing investors competitive returns. However, all of them ignore company fundamentals and can often push stocks higher without any regard for how a company or an industry is performing. Money has poured into these strategies in the past few years. As volatility inevitably rises, these trades should begin to unwind.

Passive investing is the most basic form of this investment trend and simply involves investing money in a stock market index, such as the S&P 500 for example. This strategy has rewarded investors over the course of the bull market, but despite having low fees, it still has a few flaws. To maintain the proportional stock weightings of a given index, the fund or ETF provider must buy shares in stocks that have increased, and sell shares in stocks that have decreased. This can lead to overvaluation of the companies that are consistently bought (think Netflix). In addition, because of the flows to passive investment vehicles, Goldman Sachs estimates that the average stock in the S&P 500 trades on fundamental news only 77% of the time, down from 95% ten years ago. When the markets eventually turn south and investors pull their money from these indexed products, the forced selling will likely create a cascade effect as index fund suppliers are forced to sell securities to meet investor redemptions.

Risk parity is another investment strategy that often ignores company fundamentals and feeds off low volatility. Risk parity investors make investments in a company, index, or asset class based on volatility. The strategy targets a specific volatility measure and will typically be buying securities as the volatility is declining and selling securities when volatility rises above the target. Recently, risk parity strategies have pointed to holding more stocks than bonds as the volatility of stocks has significantly declined. As volatility increases, the recent trends should flip as risk parity strategies begin selling stocks and proceed to buy bonds to "pare the risk." Many investors believe that because risk parity strategies have grown, the forced selling could create a sharp selloff in stocks – possibly creating an opportunity for the patient investor.

While these strategies continue to push stocks higher and investors likely buy every dip in the market, market liquidity is also plentiful. As a result, buyers of stocks and ETFs are not having difficulty finding sellers and vice versa – sellers of stocks and ETFs are easily finding buyers. In fact, since the Federal Reserve started tracking the data, the M2 money supply (which includes checking accounts and mutual funds) as a percentage of nominal GDP has never been higher. The elevated levels of liquidity in the markets can be the result of many factors, including the Federal Reserve's Quantitative Easing policy and low interest rates. QE,

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(Irrepressible Stock Market... Continued from page 3.)

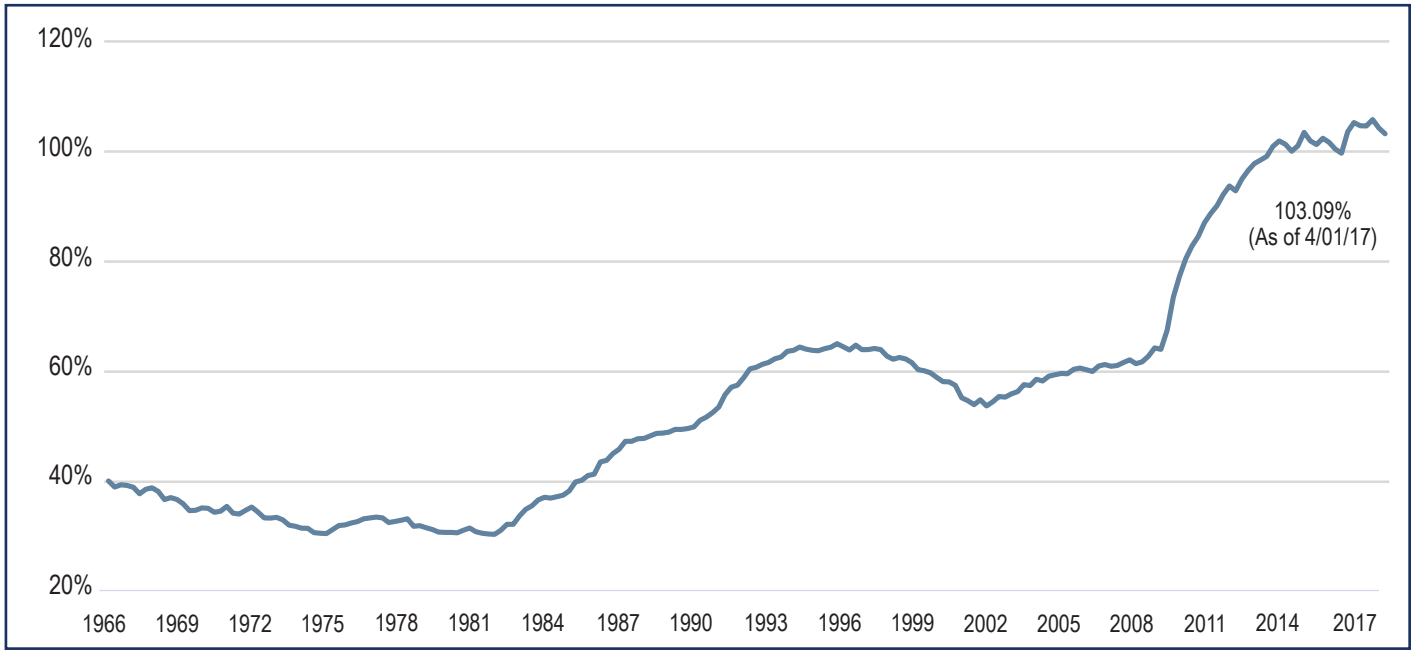
could always modify their strategy and slow the pace of balance sheet reduction. Low rates have been the catalyst for the stock market for a long time. The question is whether the economy and the stock market can support higher rates.

While Washington squabbles, the economy continues to churn upward in unimpressive but steady fashion. Annual gross domestic product growth in the range of 1.5% - 3%, par for the course since the end of the Great Recession, appears to be the new normal. However, accommodative monetary policy, gridlock in Washington, falling unemployment, and this slow but steady economic growth have provided a powerful foundation for stocks and bonds. The trends are still in place but the sands are beginning to shift.

We are at an inflection point with Fed policy. If the Fed raises interest rates, they would eventually become an economic headwind. But higher rates could also impact corporate profits in the near term, because higher rates would likely mean a stronger U.S. dollar. A stronger dollar makes corporations' exports more expensive to foreign buyers, and thus less competitive.

Corporate profits have been aided by a dollar weakened by the Fed's pivot to a slower monetary policy pace in 2017. Also menacing are the classic late-cycle signs throughout the markets. Stock valuations are elevated, the yield curve has flattened, and balance sheets are more levered. We remain cautiously optimistic but mindful of the environment as we work hard to grow and preserve your capital. ■

Total Public U.S. Debt as a Percent of Gross Domestic Product (GDP)



Source: FactSet

(Bulls Make Money... Continued from page 4.)

Even though a disciplined investment approach may sound like it's old advice straight from your grandfather's roll top desk, it's an idea that has stood the test of time. By staying the course and grinding it out over a long period, investors avoid the worst of which can happen and will happen over the years. A disciplined approach to portfolio management keeps average investors from overreacting and hurting their long term positive return that we all need to retire well. It's almost impossible to avoid the allure of "knocking it out of the park" with your investments. Just remember, as history has shown us, if you're not careful, you may end up "getting slaughtered." ■

(Volatility... Continued from page 6.)

as it is known, took the Fed's balance sheet from just under $1 trillion in 2009 to over $4 trillion today. Also adding to liquidity are additional flows into ETFs, particularly from the retail investor.

No matter what the cause of low volatility and rising markets, we at Tufton continue to search for new investment ideas and monitor our buy prices. As one investor said, "Investments are the only business where when things go on sale, everyone runs out of the store." Whenever that happens, we will be right at the front door. ■

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