TUFTON CAPITAL
MANAGEMENT

Viewpoint

WINTER 2019

For all of its joys, the holiday season also has a well-documented history as a source of stress. While they couldn't all have been hosting their in-laws for an extended visit, American investors certainly bore the brunt of that phenomenon this past December. As trees were lit and skis waxed, market commentary ranged from stunned disbelief to gallows humor. Perhaps nowhere was the mood more accurately captured than in the Wall Street Journal's Christmas Eve headline: "On the Bright Side, The Market Closes Early Today." Bah humbug, indeed.

By the numbers, this pervasive pessimism was amply justified. The S&P 500 and Dow Jones Industrial Average turned in respective tumbles of nearly 14% and 12% in the fourth quarter. Both performances were punctuated by the worst December drop either index had seen since 1931. Unable to lean upon the once-invincible "FAANG" gang, the Nasdaq followed a similar script, plunging a remarkable 17.5%. With a year's worth of gains (and then some) melted away, the perches of September suddenly felt like ancient history.

At the new year's outset, Mr. Market hardly made a compelling case for renewed hope. The first two trading days of 2019 were the bleakest in nearly twenty years. A few short weeks later, Apple cut its revenue forecast for the first time in over a decade, prompting its S&P peers to lower their collective outlooks as well. Inquiries of a "macro" scope predictably ensued. Was the economy overdue for contraction? Would trade talks with China turn sour? Should investors take cover for the year ahead?

But while this sort of market analysis kept many participants glued to their proverbial sets, the actual market did something remarkable — it got back to work. As this note goes to press, American stocks have notched their fourth consecutive week of gains. Strong jobs growth and a flexible Fed are providing a strong counterbalance to those early-January jitters. The good news isn't just local. Major indices in Europe, China, and Japan are all up at least 3% for the year. In other words, while the Grinch may have stolen Christmas, there's reason to believe he didn't make off with the next fiscal year as well.

Of course, those aforementioned "macro" questions will continue to loom. And neither I nor anything you'll find in the pages ahead will presume to answer them. (Yet again, Santa forgot to bring my crystal ball.) Instead, as we set out into 2019 together, I'll simply reiterate a principle that has guided this firm and its clients since 1995. A good business, bought at a fair price, is one of the most powerful — and reliable — wealth-creation vehicles in the world. From all of us here at Tufton Capital, we thank you for the trust you have placed in us, and we look forward to the tireless pursuit of your interests this year and in many more years to come. Here's to a Happy New Year for you and yours…and to a bit less stress come next December.

Chad Meyer, CFA
President

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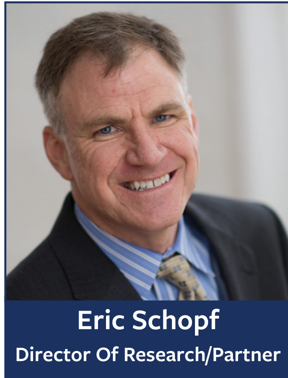
The Fourth Quarter of 2018: Forest Ranger on Duty



Eric Schopf
Director Of Research/Partner

The Standard and Poor's 500 turned in the worst fourth quarter performance since the depths of the financial crisis of 2008. The fourth quarter total return of -13.52% wiped out all performance gains for the year, which finally settled at -4.38%. It was also the worst quarterly result since the third quarter of 2011 when the S&P 500 contracted by nearly 14%. While these figures pale in comparison to the 22% correction in the fourth quarter of 2008, they serve as a good reminder about investment time horizon, asset allocation and risk tolerance.

In typical fashion, as the stock market swooned, the bond market rose. With the exception of the very shortest term instruments, interest rates on United States Treasury securities fell across the yield curve. Ten-year rates dropped from 3.05% to 2.68%. However, the ten-year rate touched 3.23% intra-quarter which made the decline even more impressive. As a proxy for mortgage rates, the ten-year rate is an important economic gauge. Rates on one-, three- and six-month Treasury Bills continued to climb during the quarter in reaction to the Federal Reserve's most recent interest rate hike imposed in December. The higher short-term rates have kept money market fund rates elevated.

The credit market, however, did not experience lower interest rates. The drop in U.S. Treasury interest rates reflected a flight to quality. The spread between rates on Treasuries and riskier corporate offerings expanded during the quarter as investment-grade corporate bonds remained essentially unchanged. The spread on non-investment grade or junk bonds widened even further as bond prices fell. The widening spread is an indication of the concerns about corporate earnings power and their ability to meet future credit obligations.

Getting to the root cause of the market turbulence requires unpacking the contents of a very busy quarter. Trade tensions persisted despite a truce between President Trump and China President Xi. Although concessions have been made by China to reduce tariffs on U.S. auto imports and to resume the purchase of soybeans, no broad trade agreement has been reached. The situation was exacerbated by the arrest of a Chinese executive in Canada at the request of the United States. Meng Wanzhou, chief financial officer and deputy chairwomen of Huwei, was arrested for violations of sanctions against technology sales to Iran. China quickly retaliated and detained three Canadian nationals for allegedly endangering China's national security.

Nationalist frictions also surfaced during the arrest and detention of Nissan Motor Company Chairman Carlos Ghosn by Japanese officials. Mr. Ghosn was initially charged with underreporting his compensation on Nissan's financial statements. As the case unfolded, news of tensions between Renault, a French automobile manufacturer, and Nissan surfaced. Renault, Nissan and Mitsubishi, another Japanese auto company, are in a strategic partnership through a cross-sharing agreement. Renault controls 43% of Nissan shares which is the sticking point with Japan. The timing of these charges seems to coincide with Japan's attempt to regain some control of Nissan.

A Federal District Court Judge in Texas ruled that the Individual Mandate of the Affordable Care Act is unconstitutional. Furthermore, he ruled that the individual mandate cannot be severed from the rest of the Act, and therefore the entire law must be declared invalid. Although the ruling may be overruled on appeal, it was one more piece of disruptive news.

The mid-term elections also dominated the third quarter news cycle. As we all now know, the Democrats took control of the House of Representatives while the Republicans maintained their majority in the Senate. The prospect of a divided house unleashed a torrent of political activity prior to the change of control.

Turmoil within the President's cabinet continued with the resignation of Defense Secretary James Mattis over a difference of opinion on Middle East policy. The President announced plans to withdraw 2,000 troops from Syria and the prospect of as many as half the 14,000 troops from Afghanistan. Mattis tendered his resignation fewer than 24 hours after the surprise

announcement.

The inability of the President and Congress to reach a budget deal led to a partial government shut down late in the quarter. With no movement in sight, the shutdown is just one more drop of uncertainty behind an already stressed dam.

The Federal Reserve delivered the decisive blow to the security market dam. Leading up to the quarter-point rate hike in December — the fourth this year, were statements from the Fed Chairman Jay Powell, declaring that the economy "was a long way from neutral" and that "we may go past neutral" in reaching policy goals. The stage was set for continued restrictive policy, and the market shuddered. The combination of higher interest rates and the continued reduction of Treasury security holdings accumulated through the years of quantitative easing have proven to be too much. The selloff continued when the Fed discounted market reaction. Steve Mnuchin, Secretary of the Treasury, made matters worse by delivering a Trump-like tweet telling the world that he reached out to the CEOs of the nation's six largest banks to confirm that they have ample liquidity for operations. The issue of liquidity was not even on the radar screen of analysts and reflected images of the financial crisis.

The U.S. economy has continued to perform well in the face of the unsettling events. Gross domestic product has remained solid and employment is still robust. Consumer confidence is high and holiday spending was strong. However, some cracks have begun to form. The Institute for Supply Management manufacturing and non-manufacturing business indexes took downturns in October and again more decisively in December. These coincident indicators are a barometer of current economic conditions. Slowing demand abroad, fading fiscal stimulus and the lagged impact of Fed policy have all played a part in the slowdown. Higher interest rates are impacting interest-sensitive industries such as housing, autos, construction and manufacturing. Business confidence also continued to slip albeit from the record levels reached earlier in the year.

We did not anticipate the fourth quarter market volatility. We viewed monetary policy as the Fed

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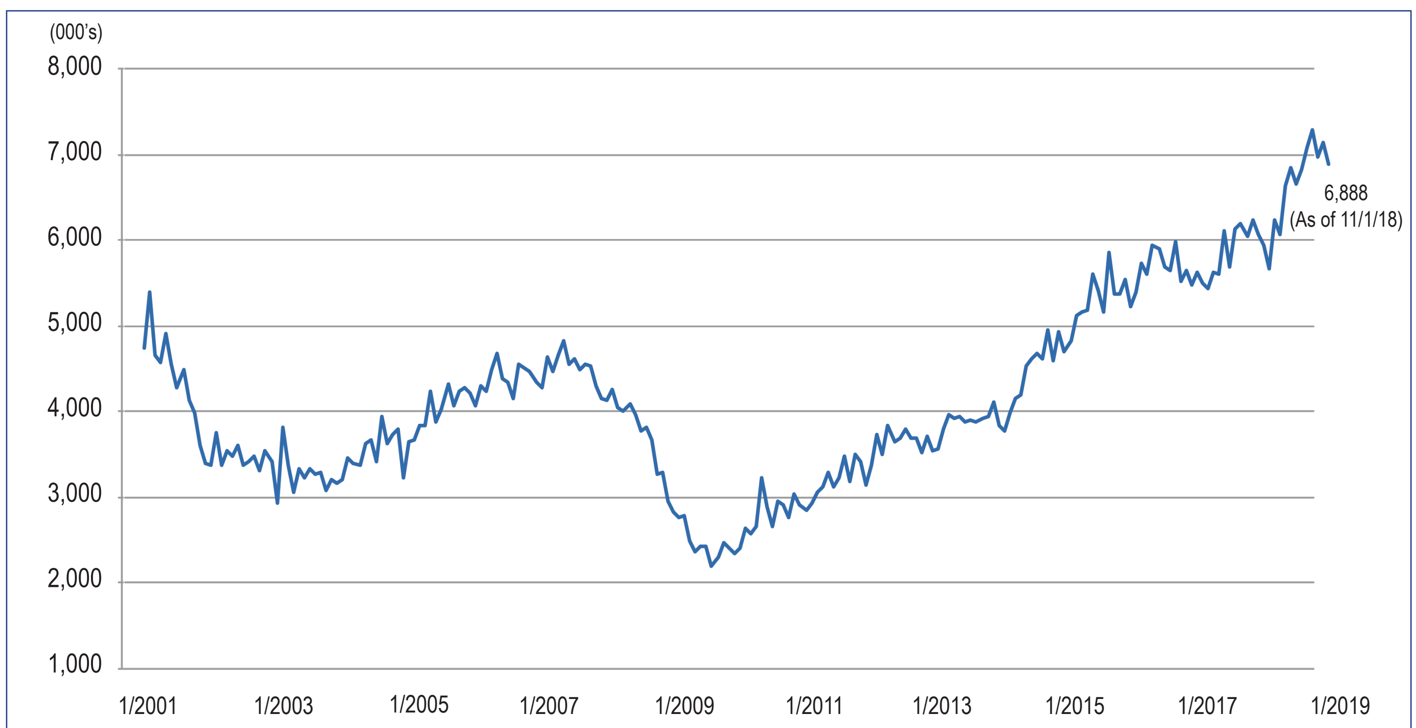
Total Non-Farm Job Openings (U.S.)



Source: FactSet

Active vs. Passive Strategies: What is Best for Your Portfolio?

Chad Meyer, CFA
President

It's an ongoing debate. Should investors use active or passive strategies in their portfolios? Proponents of active management argue that experienced money managers can outperform their benchmarks over market cycles while simultaneously positioning portfolios to avoid investments thought to have poor risk/return characteristics. Advocates of passive management, on the other hand, often point to greater tax efficiency and lower costs. Let's explain how both of these two strategies work.

The difference between an actively managed fund and a passively managed fund is exactly what the name suggests. The managers of active funds make decisions that require attention and planning to yield solid investment results. The active fund's portfolio is closely monitored and regularly adjusted to align with the manager's optimal configuration. Generally speaking, the goal of the active manager is to "beat the market", or outperform certain standard benchmarks. Conversely, a passive fund owns all of the stocks in a given market index, in the same proportions that they are held in that index. For example, an S&P 500 Index Fund will contain the same 500 stocks and weightings found in that index — no thought goes into which securities are selected (our bias towards active management may be emerging). These investments are then left to grow on "autopilot" without any regular or significant changes. For example, a computer knows that Apple (APPL) makes up approximately 3% of the total value of the S&P 500 index, and your portfolio would mirror that. Therefore, if you have $10,000 invested, you have $300 invested in AAPL.

Over our quarter-century history, Tufton Capital Management has followed a disciplined investment process where we focus on taking advantage of investors' emotions and identify mispriced securities. As long-term value investors, we are happy to move against the herd and purchase securities when the market has given up on them, and later sell them when sentiment has improved. While indexing may be an appropriate, low-cost option for retail investors, we believe a portfolio constructed entirely of these products is suboptimal for investors with sizable assets. Quite simply, these passive products in and of themselves are not tailored to meet a client's specific financial objectives or risk parameters.

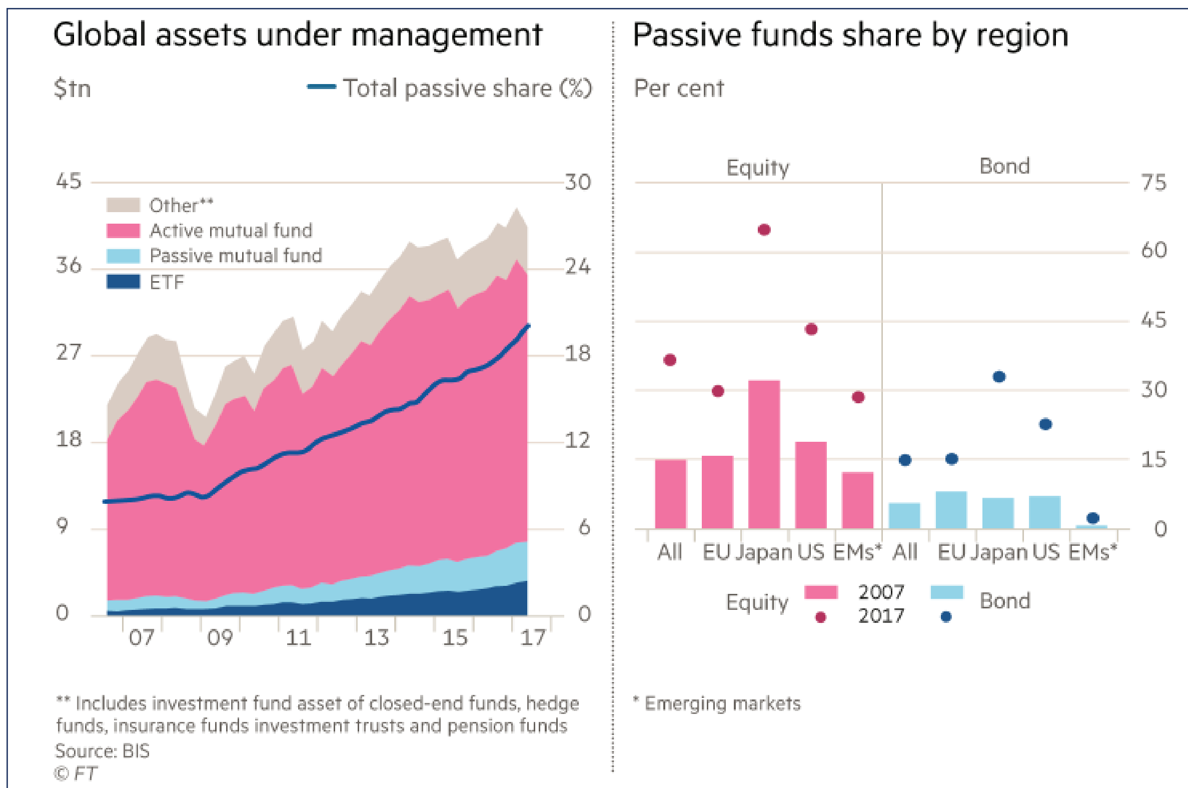
Why have investors (and financial advisors) moved towards passive indexing? First off, indexing is easy. You can purchase a few products and get a broadly diversified portfolio. Secondly, you don't need to spend a lot of time or have expertise researching or monitoring the funds, as compared to the fundamental research we perform on our individual securities. Finally, most index funds and ETFs have lower management fees when compared to their actively managed counterparts. It's no secret that only one out of five actively managed mutual funds typically beats its respective benchmark in a given year. Considering the poor performance and high fees of active funds, the move towards indexing can be a logical one for small investors, in spite of its drawbacks.

A fundamental flaw with passive indexing is that the funds often buy high and sell low to mirror the performance of a specific index. For example, when a company has done well and is added to an index, typically its business has been thriving, which would likely have already propelled shares higher. On the flip side, when a company's business has underperformed and it is removed from an index, an index fund is forced to sell and their investors have no opportunity to profit once a company's prospects start to improve. Furthermore, because indexes like the S&P 500 are market capitalization weighted, as the price of a stock

increases, the stock receives a greater weighting in the index. This conflicts with what we focus on as value investors, which is buying securities as they fall in price.

Another issue with index investing comes when indexes and ETFs are forced to trade securities only after an index's plan to add a new stock is announced to the market. Traders can "front-run" these additions and buy shares beforehand, since they know the index funds will be buying the shares when the company is officially added to the index. An example of this occurred in recent years when it was announced that American Airlines (AA) would be joining the S&P 500. Following this announcement, the stock rose 11% before it was even added to the index. Index funds were thus forced to buy the stock at a higher price. Similar to the way high-frequency traders are able game the market, this is an example of smart money taking advantage of an index fund. Over time these events may erode the returns of investing in these low-cost products.

An index fund may feel great during a bull market, but in a market downturn, index investors may be left exposed from a risk perspective. This is because an index fund may have larger positions in companies with high valuations and smaller positions in lowly valued companies. Thus, even though index investors are able to manage risk relative to their benchmark, they may struggle managing risk on an absolute basis. Without taking undue risk, our goal is to provide our clients a higher return than the S&P 500 on their equities over a full market cycle. Hence, we will stick to our guns and continue seeking to buy a dollar's worth of assets for fifty cents.



Company Spotlight: Apple, Inc. (Ticker AAPL)

Ted Hart
Research Associate

Today, it is more prudent to think about Apple (AAPL) as a consumer discretionary or consumer staple company rather than a technology hardware company. Despite popular belief, Apple is rarely the innovator for each product category; they simply improve ease of use and product appeal. Starting with the MP3 player, Apple redesigned and released their version with the iPod. In 2007, Apple "connected the dots" with the iPhone, merging the cell phone, the Palm Pilot and the MP3 into one device — all the while keeping the device small and sleek. The iPad came soon after, capturing many of the already iPhone customers. Finally, the launch of the Apple Watch in 2015 was introduced as nothing other than a luxurious item. CEO Tim Cook alongside supermodel Christy Turlington Burns released the watch at the Apple Developer Conference. The release was followed by a twelve-page advertisement in the popular fashion and lifestyle magazine *Vogue*.

The core of Apple's profits continues to be the iPhone and the price tag it commands. In 2016, Apple's market share of the smartphone market was 14.5%, second only to Samsung with 20.8%. However, Apple accounted for 79% of smartphone profits. The iPhone's presence as a luxury item became especially evident in the third quarter. Unit sales were flat year over year while iPhone sales grew 29% bringing the average selling price to $793, up from $618 in the same quarter in 2017.

Although it appears growth in new iPhone customers is waning, the hundreds of millions of recurring customers will probably continue to upgrade their phones assuming Apple's minor innovation to each new model endures and competition for a luxury smartphone remains minimal. Secondly, many customers have become attached to the iOS software and will likely continue to buy future iPhones given their ease with their current smartphones. This could be seen as recurring revenue similar to what Microsoft received from Windows software upgrades in the early 2000s.

In addition, Apple's Services business is an actual subscription model with the likes of the App Store, Apple Music ($9.99/month), iCloud ($0.99/month for 50 GB), Apple Care and Apple Pay. In the most recent quarter, Services sales surged 24% year over year with

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Apple, Inc. (Ticker: AAPL) Stock Chart

Source: FactSet

The "Magic" of Compounding and Its Effects on Earnings

Compounding is often referred to as "magical" because of the way it can help your savings grow. While its power is impressive, the way it helps you is simple math, not magic.

Compounding simply refers to producing earnings off of your previous earnings. Each time your earnings are "compounded," it means that the amount you have earned on your original investment (usually in the form of interest or dividends) has been added to your original investment, increasing both the principal and the amount that your principal can earn on its next earnings payment. With a savings account, you can usually choose to compound yearly, quarterly, monthly or even daily. With stocks, bonds or mutual funds, the most frequently you can compound may be monthly. When all other factors are equal, generally the more often you compound, the higher your earnings will be. The reason compounding gets so much fanfare (Albert Einstein reportedly called it "the eighth wonder of the world") is that it can offer you exponentially increased earnings with minimal effort on your part.

Consider an example to see how your money can grow through compounding. Let's say you invest $10,000 at age 28, with your investments compounded quarterly and earning an average rate of 7%. After 10 years, this account would be worth $20,016 — more than twice its original balance. After 15 years, that number jumps to $28,318, and after 20 years, your original investment would more than quadruple and be worth $40,064. The exponential growth that compounding creates is the reason it has so much power in the financial world.

Compounding and Retirement

Compounding can help you increase your net earnings no matter how you save, be it in a regular savings account, a retirement plan or your taxable investment account. Using a qualified retirement plan makes your earnings from compounding even more effective because your earnings can grow either tax-deferred or tax-free. While taxes chip growth away when your portfolio is in a taxable account, retirement accounts allow your investments to grow unimpeded.

Start Early

If you are just starting to earn an income or have just opened your first retirement account, retirement can seem like a far-off concept that may never apply to you. However, the power of compounding makes it crucial to start saving at a young age. Even if you think you have years ahead of you to start saving, just a small contribution beginning at an early age can grow to a large nest egg by the time you start taking retirement withdrawals. Time may be your greatest asset, and failing to save now will mean you'll have to contribute much more later just to gain the same net savings. Consider the example from the previous section. If you started saving at age 28, you would eventually end up with over $40,000 by age 48. However, to end up with the same total savings at age 48, you would only need to contribute $5,740 if you started at age 20. And, if you contributed the same capital of $10,000 at age 20, your net savings at age 48 would be almost $70,000.

Continue to Contribute

Contribute to your retirement account regularly and from each paycheck if feasible. These additions to your retirement account, added with the power of compounding, can help your account grow even faster. For example, if you made that initial investment of $10,000 at age 28 and then continued to contribute just $50 per month, instead of having $40,064 after 20 years, you would have nearly $65,000. If you automate your contributions from your paycheck and are paid twice a month, losing just $25 per paycheck would eventually help you save almost an additional $25,000.

Be Patient

Compounding only works if you allow your investments to grow. Taking the earnings from your investments rather than reinvesting them will defeat the purpose. Although the results may seem slow at first, they grow with time. If you have automated contributions set up, one of the best things you can do to allow compounding to work is to forget about it. Giving compounding time to happen can put your money to work for you, allowing you to take advantage of bigger earnings when you choose to retire. ■

(The Fourth Quarter.. Continued from page 3.)

taking their foot off the gas, not as applying the brakes. None the less, the September stock market peak to December trough was roughly a 20% correction. The future direction of the markets depends primarily on the Fed's next move. All economic expansions end and most end because the Fed raises rates excessively. Knowing this, why would the Fed continue on their current path? The primary concern in letting the economy run hot is a widely held belief within the Fed that tight labor markets lead to wage inflation and wage inflation is the primary cause of price inflation. The fear is that tight labor markets could lead to runaway inflation. For this reason, and rightfully so, the Fed is very focused on the labor market. Employment has been so strong that the Job Openings and Labor Turnover Survey presented by the Bureau of Labor Statistics revealed 7.14 million job openings in the U.S. in October. The number of job openings now exceeds the number of unemployed.

The wild fires that spread through California last year serve as a metaphor for central bank policy. A forest that grows unattended without clearing flammable underbrush and a population expanding into areas ill-suited for civilization make a natural occurrence, like fires, exponentially more dangerous. Fed interest rate policies are designed to remove financial excesses that accumulate during periods of strong economic activity. Fed regulations are attempts to prevent settlements in danger zones. The optimal level of intervention keeps the forest healthy and vibrant while excessive management stymies growth.

As we enter 2019, risks facing the markets are a Fed policy that is too restrictive and the threat of a full trade/technology war with China. The large supply of U.S. government debt may also put upward pressure on interest rates, which may impact economic growth. The U.S. budget deficit rose from $666 billion in 2017 to $779 billion in 2018. Revenue rose by 0.4% while outlays rose 3.2%. Economic growth and higher tax receipts were part of the calculus involved with the cut in corporate taxes implemented earlier this year. Positive developments would be a more accommodative Fed hitting the pause button on interest rate hikes and the impact of lower energy prices. Brent crude oil, which reached $84.25/barrel in October, fell to $53.80/barrel at year-end. West Texas crude oil experienced a similar price reversal which bodes well for manufactures and consumers.

The year will bring many challenges and opportunities. We will continue our best efforts to take advantage of the opportunities and make the new year prosperous for you. ■

(Company Spotlight... Continued from page 6.)

the App Store, Cloud Services, AppleCare, Apple Music and Apple Pay all reporting record revenues. Paid subscriptions also reached over 330 million users. With paid subscriptions now at this impressive level, that trend isn't likely to fizzle out anytime soon.

So what does all this mean for the current (and prospective) Apple shareholder? In short, it means re-conceptualizing Apple's role in the marketplace, and re-calibrating growth expectations accordingly. Rather than waiting for Apple to invent "the next Big thing," analysts and investors alike would do well to judge the company against its true strengths: pricing power, customer retention and a knack for sticky and diverse streams of recurring cross-sell revenue. While this view would perhaps undercut the narrative of "Apple magic," it would also permit a franker, more clear-eyed discussion of one of the country's most prominent stocks. And that's a luxury we can all afford. ■

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