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Economic and Market Commentary

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In the middle of the last Ice Age, the land that became Vermont was covered in ice two miles thick. By the time it melted, an inland sea was formed that brought landlocked salmon, lamprey and spelt. Ancient whale bones have been recovered from Lake Champlain.

During the time that became known as the Archaic Period, nomadic Native Americans hunted and foraged the region for more than 6,000 years. Around 1000 B.C. to the early 1600s, what anthropologists term The Woodland Period, complex societies of Algonquin, Mohican and Abenaki people developed, and life was good. Things were about to change.

First Contact

Although it's believed that Jacques Cartier was the first European to see Vermont in the early 16th century, it was actually French explorer Samuel de Champlain who claimed the land for his king. He gave the mountains of the area the appellation, Les Verts Monts, the green mountains, the state's nickname to this date and the genesis for its name. Around this time it's believed that some 10,000 native Americans inhabited the area: Algonquin, Aquia and Western Abenaki were the dominant cultures.

Well, it didn't take Sam very long to get enmeshed in local politics. Before you knew it, he had several of his men assassinate an Iroquois chief with an arquebus to get on the right side of his new Abenaki allies, a heinous act that haunted the French for the next 150 years and in part contributed to their defeat in the French and Indian Wars. You see, the Iroquois had a long memory, and ultimately sided with the British to defeat the French and kick them out of New England. Between wars and plagues, the first nation's people were decimated, and by the early 18th century, European settlements began to flourish amongst the green mountains.

Vermont Firsts

Amid fertile lands and a harsh climate, a culture of strong, fair and independent-thinking people prospered. A few noteworthy accomplishments would have to include:

1775 Ethan Allen of the Green Mountain Boys and Colonel Benedict Arnold capture Fort Ticonderoga in the first colonial victory in the Revolutionary War.

1783 Lemuel Haynes becomes the first black pastor of a white congregation in America.

1790	Vermont creates the first state university.
1791	Vermont becomes the first state to outlaw slavery.
1823	Alexander Twilight becomes the first black in America to receive a degree from an American college.
1846	The first U.S. postage stamp is printed in Vermont.
1940	The first social security benefits check in the amount of $22.54 was issued to Ida May Fuller, a Vermont widow.
1954	Consuelo Northrup Bailey is elected the first female Lieutenant Governor in U.S. history.
2000	Vermont establishes the first "domestic partnership" statutes providing gay and lesbian couples the right to register their relationship and receive the same rights as heterosexual couples.

Here Comes the Kid from New York

With almost a surreal natural beauty, this cold and somewhat remote patch of New England challenged me to come see if I could weave myself into its fabric. Just shy of 19, I drove cross-country to transfer to a small writer's college called Windham, just up the road from Sacketts Brook, in the town of Putney, Vermont.

It didn't take me long to discover that Vermonters, in general, are quiet by nature, fair-minded and fiercely independent, characteristics I grew to admire and respect as I advanced through my studies over the next several years. It was in September of my senior year, just back from a year's study in England, that a chance encounter would change my life.

Vermont's First Town

Although Windham was mostly known for a superb English Department with writers like Remington Rose, a young John Irving (who recently published his first novel, *Setting Free the Bears)*, and my own favorite, Dr. Hal Hurwitz, their library left something to be desired. Now the Brooks Memorial Library, nine miles down the road in Brattleboro, was a different story. Brattleboro was the big town in these parts, in fact the only town in the state to have three exits on I-95. Brattleboro was the first permanent English settlement in Vermont, and it boasted a population of about 7,000. The town took its name from Colonel William Brattle, Jr. of Boston, who never set foot in his namesake municipality.

Being on the Connecticut River, Brattleboro had a lot going for it commercially back in the 19th century—grain, lumber, turpentine productions—and from my perspective, best of all, it enjoyed

the generosity of a philanthropist named George Brooks.

George had grown up in nearby Chesterfield, New Hampshire, and he made his fortune from a wholesale paper business he started on the West Coast. When he returned to the East in the 1880s, he had made a bundle and wanted to give back. He built a most wonderful library, stocked it with a collection of more than 5,000 books and left an endowment for its care and maintenance. By the mid-1960s, the library had outgrown its original quarters and moved to a beautiful new facility at 224 Main Street in downtown Brattleboro.

A Chance Encounter

Back in those days when I would venture into town with my dear friend Bill, you would typically find us in one of three places— Charlie's Pool Hall playing eight-ball, the Village Barn Bar and Restaurant working on our dating life or at Brooks Library hitting the books.

One day in late September, I found myself at Brooks going through the stacks, working on a paper. The aisles of the library were narrow, and two people couldn't pass each other at the same time going in opposite directions. Coming toward me was a strong, barrel-chested guy wearing the quintessential Vermonters plaid shirt, blue jeans and Dunham boots. He was balding on top and had a big mustache and bright clear eyes. He greeted me with a, "Hello there, Ray, how are you doing?" Well, it was one of those moments where the guy clearly knew me, and he did look familiar, but for the life me, I couldn't place him.

After an awkward moment, he stuck out his large calloused hand and kindly said, "Ron. Ron Read. From the Esso station on Green Street. I took that 16 penny out of your front right on that Chrysler of yours last week." Sure, that was it, the last time I saw this guy, he was wearing a green Ben Davidson jumpsuit with an oval breast patch that said Ron on it. He was wearing the same Dunham boots, best work boots in the world made in Ottawa Canada. I still have mine from college (a true case of buying the best and getting your money's worth).

So now that I had placed him, I returned his handshake and proceeded to make a total ass of myself by saying, "Yeah, hi Ron, good to see you, what are you doing here?" Have you ever said something really, really stupid and literally see the words coming out of your mouth and wish you could physically pull them back with your hands and stick them back in that big stupid mouth of yoars?

Well, that was me at that moment. But lucky for me, Ron was a tolerant guy, and he simply said, "Not everything is taught in college. Follow me and you'll learn something."

Without a moment's hesitation, I followed Ron, who walked with a bowlegged gait down the aisle and around two corners. Now we were in the business and finance section of the library when he looked at me, then said, "Ray, I do two things in life very well, chop wood and invest." At that moment, he turned and reached up to the next-to-last shelf, pulled down a red-jacketed 600-page tome entitled, *The Intelligent Investor*, and slapped it onto my chest saying, "Now this guy knows what he's talking about." With those parting words, Ron took off, going about his

business in leaving me there to thumb through the first few pages of *The Intelligent Investor* by Benjamin Graham, published by Harper & Brothers.

Like A Light Bulb Going On

All right, I'll admit it. Even though I was no economics scholar, I had heard of Benjamin Graham. Not only was he co-author with David Dodd of one of the most highly regarded books on securities of all time, *Security Analysis*, he was the central player in what came to be known as "The Northern Central Pipeline Affair." As an ardent student of history, even in college this was a story I was familiar with.

Back in 1911, John D. Rockefeller was the wealthiest man on earth. The U.S. government had just curtailed his monopolistic practices by splitting up his Standard Oil Company into 34 different corporations. One of these companies was the Northern Pipeline Company, which was trading on Wall Street at $65 a share in 1926. It was then that young Benjamin Graham, working as an investment banker for Graham Newman, a firm he co-started, reviewed a sketchy financial report about the company and got suspicious. They were, in essence, hiding assets. Graham took a train down to Washington, reviewed the Interstate Commerce Commission's records that contained Northern's detailed filings to learn that they were sitting on $95 per share of unrelated railroad bonds and other liquid assets.

Graham singlehandedly discovered these hidden assets, and throughout the next year, started buying up Northern's shares. The showdown came in 1928 when Graham had the proxy votes of 40% of the outstanding shares of Northern and compelled management to distribute to the shareholders $70 per share of excess liquid assets. This affair represented the birth of activist investing and cemented Graham's reputation, at the age of 34, as a brilliant analyst.

What caught my eye was the preface written by Warren Buffet, Kathryn Graham's friend, who just got named to the Board of Directors of the *Washington Post*, the same *Washington Post* that had broken the Watergate story the previous summer. There it was. "By far the best book on investing ever written." Okay, I was sold, so I checked it out.

Some Unexpected Reading Time

It wasn't two weeks later that I was hit head-on by a drunk driver in a pickup truck. Lucky for me, the Chrysler Town and Country station wagon I was driving at the time was the heaviest car made in America. I escaped this life-threatening occurrence with a small broken bone in my wrist and a bunch of bumps and bruises. The doctors at Brattleboro Memorial sent me home with the instructions: Go home, take it easy for the next week or two, and read a good book. How fortuitous. I knew just what I would read.

So you might be thinking about this time, why am I recounting a read from so many years ago? What's the relevance? Since the market bottomed from the Great Recession in March 2009, it has been on a steady upward trajectory with a few setbacks here and there. Many have come to call it the Teflon market, one that doesn't let any bad news stick to it. But as the old Wall Street

adage goes, “Trees don’t grow to the sky,” meaning we need to be prepared for the headwinds facing the U.S. equities market and to engage in a disciplined strategy that provides us, as investors, with strong margins of safety, one of the central themes of *The Intelligent Investor*.

Probably later this year the Federal Reserve will start raising rates. The strong dollar looks to be a drag on trade and earnings, and profit margins could be at a peak. Widespread investor optimism is a concern (never get complacent about the markets) and above average earnings multiples could leave the market vulnerable.

Dick Young, a financial writer for 50 years and a disciple of Benjamin Graham, refers to it as the 4P’s: Preserve and Protect via Perspective and Patience.

Over the years, I have frequently written about Putney’s investment bias, trying to protect our portfolios through allocation selection from taking oversized hits in down markets. Again, our goal is to try to achieve a 7% - 8% compound return over the three and five-year cycles with the least amount of risk as possible. We’re talking about Preserve and Protect here. Let’s see what Benjamin Graham had to say about Perspective and Patience.

Mr. Market

Graham always believed that when you buy a stock, you own part of the business. If you start thinking that way, you shouldn’t get overly concerned with day-to-day or week-to-week fluctuations in the stock price. He described the stock market in the short term as a voting machine, but in the long-term, like a weighing machine. So, if you pick quality and buy well (not chase stocks through momentum buying), a company’s true value will, in the long run, be reflected in its stock price.

Graham’s classic explanation of this discipline is his anecdotal description referred to in his book as “Mr. Market.” Mr. Market is described as an amiable fellow who shows up at your door every day. When he does, he is prepared to buy your shares of a company at a particular price or sell you more shares at that price. Now sometimes his prices will seem reasonable, and sometimes they’ll seem out of whack, either too low or too high. If you don’t want to do business with him, you don’t have to. His feelings won’t get hurt, and he’ll come back the same time the next day and do it all over again. Graham’s point was not to let the market determine the value of the business you own. As he put it, “You should profit from market folly rather than participate in it.”

A number of years ago, I came across a wonderful and straightforward explanation of Mr. Market that was offered by a reviewer of *The Intelligent Investor*:

“The stock market on a daily basis resembles a casino, only without the comfort of free cocktails. Watching the stock ticker is like having a business partner that is totally schizophrenic. Graham calls him Mr. Market. One day he loves the business and wants to pay the ridiculous price to buy out your half. The next day, all hope is lost, and he wants to sell you his portion for pennies on the dollar. Graham argues that this daily liquidity is an advantage that most investors turn against

themselves (page 203). '"But note this important fact: The true investor scarcely ever is forced to sell his shares, and at all times, is free to disregard the current price quotation. He needs to pay attention to it and act upon it only to the extent that suits his book and no more. Thus, the investor permits himself to be stampeded or unduly worried by unjustified market declines in his holdings is perversely transforming his basic advantage into a basic disadvantage. The man would be better off if his stocks had no market quotation at all; for he would then be spared the mental anguish caused him by other persons' mistakes of judgment. This is profound. It's not a question of whether our stocks will drop; they will. The trick is how we respond to that eventuality."'

The Enemy Within

A few months back, Lew Braham, a Pittsburg-based financial columnist, wrote an article for *Barron's* entitled*, "*The Enemy Within*,"* which illustrates perfectly how, in real life, when left to their own devices, investors so often become their own worst enemy when dealing with market volatility.

During the course of the article, Braham talks about investors' frequent habit of "trying to dodge the bullet" by pulling out of declining markets at the worst of times. To prove his point, he examined two excellent mutual funds from the same shop. Both the Oakmark Select (ticker OAKLX) and Oakmark Equity Income (ticker OAKBX) funds have fine long-term records, having beaten most of their peers over the past 10 years with returns exceeding 8%.

Here's where it gets interesting: The Oakmark Select fund has averaged an 8.3% rate of return in the last decade, but back in the mid-2000s, the fund held a fair amount of bank stocks like many mutual funds did at the time. After all, the bank stocks were high flyers— remember Ninja Loans? No job, No income, No assets, yet the bank would still lend you the money to buy the house. Well, among Oakmark Select's holdings was Washington Mutual which imploded. Oakmark Select went down 17% in 2007, and another 36% in 2008 before bouncing back. So, although the mutual fund average 8.3% over the last 10 years, its average investors over that same time averaged just over 5%. Why? Because so many investors got nervous at the extreme volatility and tried to "dodge the bullet" by getting out at exactly the wrong time.

Investors in Oakmark's Equity and Income fund, on the other hand, had a very different experience. The fund typically had a much more diversified mix of assets, including a strong representation of fixed income securities and other yield-bearing instruments. They steered clear, in large part, of the high-flying stocks and brought in lower returns than their daredevil twin in the up markets.

But when 2008 came around, the fund fell only 16.2%, and investors held their ground. By avoiding the big hit in a down market (sound familiar?), they didn't try to dodge the bullet and fared quite well. The funds annualized 10-year investor return is 7.3%, very close to the fund's actual 10-year return of 8%.

Let Me Bring It Home

Back in the spring of 2001, I've been told that Britney Spears had a hit song entitled, "I'm not a girl, not yet a woman." I've heard the 2015 equities market described in similar terms, "Not a Bull, not yet a Bear."

It's my belief that we're entering into the second half of a long U.S. expansion, one that could last another three to five years. With that said, it's important to realize that we are transitioning out of a recovery rally and into a period of lower returns as the benefits of margin expansion and share repurchases prove to be already priced into the market. As labor regains pricing power and borrowing costs move higher, corporate profits can be dampened. But as is always the case, positive forces are also at play boding well for sustained but moderate equity returns.

Most analysts we follow believe that the bias for stock prices in general remains to the upside. One important consideration is that the average age of plant and equipment is at its highest levels in 50 and 15 years respectively. That means there is a tremendous amount of pent-up investment spending and demand for companies to improve their growth prospects by investing in their business. Obsolescence is playing a positive role here.

In terms of our own portfolio positions, stocks certainly look more attractive than bonds, but portfolios still need to be balanced and cannot rely solely on equities and cash (remember Oakmark Select). We will continue to use short-term floating-rate loan instruments, equipment leasing, NNN (triple net) leases, senior debentures and other alternative yield-centric instruments designed to deliver predictable returns and dampen volatility. Although returns may compress for U.S. equities, from the outsized gains seen in the last four or five years, new opportunities are presenting themselves abroad as a result of a weakened Euro approaching parity, thus making European exports more attractive. Additionally, Quantitative Easing abroad (think of the positive market effects here in the U. S. when we introduced the QEs) and lower fuel costs can add to foreign stock appeal.

So, as the year progresses, it is our intention to strategically position our portfolios to take advantage of the faster earnings growth and lower valuations from international stocks by gradually increasing our foreign holdings in developed Europe and select emerging markets. On a complementary theme, we will take great care in our future positions of large cap U.S. multi-nationals that will continue to be challenged by the strengthening U.S. dollar.

The U.S. equities market, buoyed by strong corporate balance sheets anchored by steady-if-modest earnings growth in select industry sectors, should produce moderate gains in the choppy environment as we move deeper into the presidential cycle.

As is always the case, I look forward to our periodic review.

Best Regards,

Ray Lent
RLL/dot
Enclosures

Post Script. Last spring, I was sitting in my family room with my morning coffee and three newspapers. CNN was on in the background, when I happened to look up and saw a young newswoman standing in front of a library, which turned out to be the Brooks Library. There at the bottom of the screen it said Brattleboro, Vermont. Now they had my attention.

The story went on to report that a local World War II veteran had passed away at the age of 92. Apparently, the man was known for his frugality, scruffy appearance and relaxed sense of humor. He died a widower, and when his attorney, Laurie Rowell, went with the banker to open up the man's safety deposit box, they found his will and stock certificates. Lots and lots of stock certificates. It seems the elderly man of genteel deportment had amassed quite a nest egg for himself and had decided to leave the lion's share of his eight-million dollar estate to Brattleboro Memorial Hospital and the Brooks Memorial Library. The man's name was Ronald Read.