Dear Fellow Investor:

For the past several years, investors have been focused on the Federal Reserve and its extraordinary efforts to stimulate the economy by keeping interest rates low and creating a "wealth effect." The Fed created several ***trillion*** dollars and used them to purchase treasury and mortgage-backed securities. As the former owners of these bonds reinvested the proceeds, the new cash spread into adjacent securities markets, including stocks. The idea was that if cheap credit were readily available and investors and companies felt confident about the future, they would invest in new businesses and capital equipment, thus stimulating the economy and creating jobs.

One could argue that the actual effect was to inflate securities prices and increase the wealth of investors without having the desired positive impact on the U.S. economy. Nevertheless, investors seemed to believe that as long as the Fed kept interest rates near zero and did not "take back" the newly-created liquidity, it was safe to bid up stock and bond prices. Some referred to this belief that the Fed had created a "floor" under securities prices as the "Yellen Put."

In recent months, reality has reared its ugly head, investor confidence has waned and the stock market has been volatile. The reasons for growing doubts are varied and complicated, but they seem to center on fears that a slowdown in the Chinese economy is impacting the rest of the world in negative ways. Global demand for iron, coal, copper and other commodities has fallen significantly. The surge in supplies of oil and gas from expanded shale extraction in the U.S. has created challenges for energy producers and the countries that depend on oil exports. Turmoil in the currency markets stems from the efforts of China, Japan and others to devalue their currencies to stimulate exports. The dollar is now one of the strongest currencies and this causes headaches for emerging market countries whose debt is denominated in dollars. Dollar strength also affects the competitiveness of domestic exporters and depresses the reported earnings of American companies whose profits earned abroad translate into fewer dollars.

Not one of these issues is new. For several years, each has been on the list of "things that ordinarily would be worrying investors." Now that they are back on investors' minds, stock prices have been weak. Most market indices have given back their first-half gains and are showing red ink for the year-to-date period. Our funds are also showing losses. This table shows fund performance over various time frames. As always, we suggest investors focus on longer-term results as they are the most meaningful.

We have been lamenting the absence of volatility for years, and now we have some. There was a popular TV show from the 1950's called "You Asked for It!" (You can check it out on YouTube—it was really awful.) At any rate, sometimes I imagine shareholders looking our way and saying, "OK, you asked for it. What now?"

Navigating a Choppy Stock Market

There was a five-day stretch in August during which the S&P 500 dropped 11%—the first "correction" of over 10% since 2011. Several trading days during the quarter saw sharp moves (in both directions), and the financial press did its best to create anxiety among investors. Most of the companies we own and those on our "on deck" list participated in the decline. While we don't celebrate declines in the value of our investments, cheaper prices often present opportunities to deploy our cash reserves, making investments that we expect to generate profits in the coming years. The big questions, though, are how long and deep will the correction be, and how aggressively should we buy as stocks fall?

As clients would expect, there are no magic answers. Investing is as much art as it is science (maybe more). There are facts and hard news. There are guesses, opinions and inaccurate information that are often mistaken for facts. There can also be intentionally misleading (!) information disguised as facts. Given the uncertainty about the health of the global economy and the rather extended level of stock prices, as we've seen recently, anything can happen.

Our method of dealing with this hodge-podge of factors is to ***focus*** on the business values of individual companies. We believe that the value of a business to its owners is the price today that an informed buyer would pay for the right to receive the cash that business will earn in future years. That price is an estimate based on (presumably) informed predictions. The estimate is subject to change as the business landscape changes, but ***generally, the value of a business changes much more gradually than the company's stock price.*** So, as emotions drive investors to overreact to imperfect information, a stock's price can move far below (or above) that company's business value.

We try to buy stocks at a steep discount to their underlying business values (V). Ideally, we will pay a price (P) equal to 50-70% of our estimate of value (a P/V of 50-70%). The value is an estimate, and we are not rigid about the price we pay, but over the decades, the lower the initial P/V, the higher the subsequent profits. We also track each portfolio's weighted average P/V. Again, as you would expect, portfolios tend to perform better from lower P/V starting points. So, we welcome (temporary) dips in prices.

This approach has worked very well for us over the past 30+ years. Business value is (roughly) measurable and it acts as a powerful "gravitational force" on a company's stock price. Investors usually (eventually) recognize business value, and if not, a buyer of the whole company may take advantage of the bargain. Unfortunately, the ***timing*** of the reconciliation of price and value is always a mystery. As John Maynard Keynes famously quipped, "The market can remain irrational longer than [a speculator] can remain solvent." This is why we avoid taking extreme positions and like to hold cash reserves (sometimes substantial ones).

In the recent turmoil, prices of both current holdings and stocks on our "on deck" list declined to more "interesting" levels. The average P/V of our stock portfolios declined to the 70-75% range at September 30 from levels of 85-90% earlier in the year. We have been able to buy more of some current holdings and to add a few new companies to our portfolios. (Details on a fund by fund basis are available in the quarterly commentaries.)

Our pace of buying will depend on valuations—P/V levels—***not*** on any attempt at "market timing." If prices resume their multi-year levitation, we will be patient and will not chase them. If they fall sharply, we will be buyers, even at the risk of being early. More likely, they will wander sideways within a (possibly wide) trading range, and we will buy opportunistically. The beauty of owning companies with strong competitive and financial positions, bought at reasonable prices, is that we know we have a high probability of eventual success.

Many of the global economic problems in today's headlines are real. We tend to discount the extreme predictions of global economic collapse, but there are investors, companies and countries with challenges that are interrelated and which may take years to resolve. We have been wary of valuation levels and economic crosscurrents but remain confident in our methodology. We welcome the emergence of new investment opportunities, and we appreciate our long-term shareholders who have a way of sending in more of their savings when markets weaken.

Sincerely,

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