KLCM Advisors, Inc.

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Take Dead Aim

After the winter rollercoaster, the arrival of spring ushers in a new start for stocks. After having fallen as low as -10.5% in early February, the March rebound pushed the S&P 500 all the way back to even for the year. The market leadership in the rebound has been concentrated among the most economically sensitive parts of the market; the same sectors that led the way lower.

To <u>some</u>, this move suggests that two of the biggest investor concerns, slowing economic growth and tightening monetary policy in the US, have abated. Economic data in the US has remained generally positive, especially continued strength in employment and auto sales. Additionally, the stance of central banks globally, including our Federal Reserve, has taken a dovish turn, despite some ‘stray’ commentary from a few Fed governors. This has led many to believe that the March 2016 recovery can continue unabated for the balance of the year.

We <u>do not</u> subscribe to that view. Our expectation is that we are in the later stages of an economic, profit, and market cycle, and as a result we will see more volatility in both directions (similar to Q1 2016). Headline risk from all corners of the world will continue to move the market. Corporate profit growth has turned negative year over year, led by energy, basic commodities, and export driven industrial firms. In this environment, strategies that have worked in the past, (read momentum or growth styles of investing) will be less effective. Achieving real rates of return in this environment will require selecting individual stocks that have improving fundamentals and reasonable valuations. ‘Shooting with a shotgun’ works in the early stages of an economic and market recovery when earnings and valuations are generally rising. Now is a time for prudent risk taking.

The good news is that the current market setup favors our investment process and approach. A bottom-up view of stocks will provide us with a focused view of the market. When we find low-expectation and under-valued stocks, we can construct a portfolio with attractive risk/reward characteristics. It requires patience and we often have to live through volatility, but it has proven to be rewarding. Here are a few examples of recent purchases that fit our criteria.

<u>McKesson Corporation (MCK)</u>

McKesson Corporation is an international pharmaceutical distributor. The company had a difficult 2015, losing all or part of three large client contracts due to end market industry consolidation. This resulted in reduced revenue and earnings growth. In addition, a slowdown in generic drug price inflation further pressured income growth. These fundamental headwinds have weighed on investor sentiment, causing the stock to trade down towards the low end of its historical valuation range (12X current year’s earnings). Even with these short term headwinds, we see fundamental improvements on the horizon.

McKesson's 2014 acquisition of European distributor Celesio is currently being integrated. Margin expansion in this segment will occur as McKesson applies its best practices to this previously undermanaged asset. The company will also benefit from increased purchasing

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power obtained by consolidating US and European drug volumes, while at the same time continuing to consolidate generic drug purchasing around the world.

With political uncertainty casting a shadow over the healthcare sector this year (a shadow that occurs every election cycle), we were able to enter the stock after earnings expectations were reduced, at a very reasonable valuation. If our bottom-up work on the benefits of increased purchasing power and margin expansion at Celesio are correct, we stand to be rewarded over time with a higher multiple on a higher level of earnings.

International Business Machines Corporation (IBM)

IBM has spent the last 7 years repositioning itself from a hardware centric company to a company whose growth will be driven by sales of software and services. To accelerate this transformation, the company has divested legacy businesses and spent more than $8 billion acquiring new data and software companies. The company has also been taking advantage of its prodigious free cash flow to continuously invest in R&D, spending more than $1 billion a year over the past decade, allowing for the development of products such as Watson. This investment is paying off as the data and analytics business units of the company are growing quickly and currently make up more than 30% of revenue with better growth opportunities and higher profit margins then the legacy hardware businesses.

When the company first unveiled this plan several years ago, investors were excited at the prospects of yet another transformation of "Big Blue". From 2013 until now one could always have made the case that IBM was "cheap" but the inflection point, from revenue and earnings declines to growth, was still years away.

We believe the revenue declines reached a crescendo in the second half of 2015, with a very strong US dollar further suppressing international revenues and earnings. The fourth quarter earnings were reported in the midst of the significant market weakness in January, which put additional pressure on the stock. The combination allowed us to purchase IBM at 10X reduced 2016 earnings estimates with a nearly 4% dividend yield. As we look forward we believe that once IBM returns to revenue growth, earnings and cash flow growth will follow. We believe investors will be attracted to the growth characteristics of the "new" IBM, and that we will benefit as shareholders through continued dividend increases and significant long term share price appreciation.

These are two examples where we were able to find companies that have better than average earnings prospects, but whose stocks were selling at a substantial discount to the market. If our work is correct, these companies should both be able to exhibit faster earnings growth than the rest of the market, allowing our shares to meaningfully appreciate. If the economy or market should weaken, then the relatively low valuations we have paid and modest investor expectations should limit our downside. Being seven years into this economic and market cycle makes these opportunities more difficult to find; however we believe the increased volatility of the market will continue to provide these types of opportunities to take dead aim and deploy capital.