KLCM Advisors, Inc.

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Reality

If recent developments in Washington haven't made you a bit uneasy, you are extremely successful at tuning out the noise. In our last essay we wrote "given our cynicism of government, especially in Washington, we expect some challenges in policy implementation as the New Year begins. These challenges, in our opinion, will provide real opportunities for investor sentiment to change course…" This reality is upon us.

While beltway politics have been "challenging" (as expected), our view that market volatility would follow has been completely wrong… so far. We have just experienced one of the least volatile periods in recent equity market history. There were 110 consecutive trading days without a 1% decline in the market; the longest streak since 1995. This run finally ended March 21st. Needless to say, the tranquility has been surprising.

While Washington's difficulties suggest more political uncertainty, one should keep the events in context. Economic data in the US continues to improve, and all of the top global economies are expanding in unison for the first time in a decade. We believe that strong US economic fundamentals remain intact (multiyear highs in consumer and business sentiment, tightening labor markets, increasing demand for housing, strong consumer balance sheets). Add a pro-business policy agenda and a reasonable backdrop for sustainable economic growth takes shape. Longer term, these fundamentals will drive the market.

While we expect that the economy will grow in the coming year, we continue to gird ourselves for increased volatility and the potential for a market pullback. We are entering the later stages of a long economic expansion; volatility tends to be elevated in the 2nd half of a business cycle. To that end, our portfolios are more conservatively positioned. We continue to keep some cash on hand, and seek out larger, higher quality businesses, illustrated via two of our more recent purchases.

Merck (MRK)

Large pharmaceutical companies historically go through long periods of time where one company is viewed as the leader in drug technology. This position manifests itself in higher growth rates than peers and an accompanying higher valuation from investors. For the past decade Bristol Myers has held this position with its leadership in an emerging class of cancer therapies: Immuno-oncology drugs.

Late last summer a highly anticipated Immuno-oncology drug trial conducted by Bristol-Myers failed. This catapulted Merck into the leading position in this space. We believe

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the successful trials Merck has conducted on their I/O drug, Keytruda, will change the landscape and leadership in cancer treatment. The shift away from radiation and chemo towards I/O has begun to take mindshare at leading medical institutions.

This can be seen by Massachusetts General adopting Keytruda's biomarker testing in select cancer treatments as their new standard of care.

We believe we are at the forefront of change in leadership within the pharma sector. As Keytruda starts to flow through Merck's operating results they will be able to grow earnings faster than their peers and should be rewarded with a premium multiple. While we wait for this scenario to play out, we own a great global franchise trading at lower than market valuation and we will collect a nearly 3% dividend yield.

Occidental Petroleum (OXY)

Depending on how you categorize the industry, Occidental is either the smallest major or the largest non-major integrated oil exploration and production (E&P) company. Either way, the integrated business that only scale players possess offers unique advantages in the energy space. One benefit is the ability to invest throughout the commodity price cycle. Occidental spent $2.6 billion in growth project capital over the past three years. Due to their integrated business model and historically conservative approach to capital allocation, the company was able to do this while also raising the dividend 19% and maintaining a single "A" balance sheet.

Having completed this spending, the company is now in the enviable position of harvesting a return on this sizable investment. Completion of these projects allows the company to focus on deploying their growth capital towards the Permian basin. Here the company has a 650,000 acre core position where they have identified over 2500 drilling locations that are profitable with oil below $50. After doubling their current activity level, this will still represent more than 10 years of drilling inventory.

With most investors having thrown in the towel on energy companies after a difficult three year stretch, the stock has found no takers. In fact, despite crude nearly doubling, the stock is up only a few dollars from where it was last February when oil was $28/barrel. We believe as the price of oil stabilizes and true investors return to the energy industry, Occidental will be rewarded with a higher share price. In the meantime we will happily collect the generous, safe, and growing 4.7% dividend.

These are two examples where we were able to find companies that we believe have better than average business prospects, but whose stocks are selling at a discount to their peers. If our work is correct, these companies should be able to increase their free cash flow as they reap the rewards of past investment. If the economy or market should weaken, then the relatively low valuations, strong balance sheets, and meaningful dividend yields should help limit our downside.

Thank you for your confidence and enjoy spring!