CAIRN INVESTMENT GROUP

Newsletter and Quarterly Update

September 2018

Inside This Edition:

Important Reminders:

- **Bank Holidays: Oct. 8 & Nov. 12 No Checks or Settlements**
- **NYSE Closed for Thanksgiving**
- **NYSE Early Close Nov. 23 & Dec. 24**
- **NYSE Closed for Christmas**

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Greetings from the Northwest.

The unexpected has become the expected, the bizarre has become commonplace, and the unpredictable is where we are. As investors our goal is to purchase equity in companies or debt from a variety of sources at a value price. Later, our goal is to sell equities at a higher price and debt instruments at their maturity value. The single biggest question over the last quarter from our clients has been: "Can this economic expansion keep on going?" The most common concern is that no one wants a repeat of the past recession or corrections. Got it. No easy task. We have found that it is extremely difficult to "time" the market. So we don't. What we can do is pay attention to valuations and the "expensiveness" of what we own. Expensiveness? Patrick will explain. We are reducing our exposure to market fluctuations by reducing the "expensiveness" of our investors' portfolios.

Smokey Sunrise in the Oregon Canyon Mountains *Photo by Tim M.*

Patrick's Part

The U.S. equity markets pushed aside many headline risks to finish up 7.71%, as measured by the S&P 500 Index. Its best quarterly return since 2013. The same could not be said for international equities, as concerns over global trade and growth caused broad-based international indices to return only 0.76%, lagging behind their U.S. counterparts by a wide margin. The large positive return for U.S. stocks over the quarter did nothing to improve valuations, which are near historical highs. We have talked about this numerous times over the last couple of years, so we want to touch on our process and how we are generating positive returns with much lower risk of permanent impairment of capital. Lastly, I will go over some updates that have taken place within the S&P 500 Index which could cause some changes in how investors view certain sectors going forward.

Through our quarterly letters and individual meetings we have discussed our process for uncovering successful investments, our current view of U.S. stocks, and how we are managing assets concurrent with that view. First, we are always on the lookout for industry leading companies that generate significant cash flows, with balance sheets that can provide financial flexibility. The final, and what we believe is the most important piece, is paying a price for a company that is significantly lower than what our analysis says the business is worth. We use a combination of cash flow analysis and the historical operating performance of the business to identify suitable investments, avoiding ones for which we would be paying too high a price, therefore limiting appreciation potential. The end result is that your portfolios are less "expensive" than the broader market, which should help us to weather bouts of higher volatility

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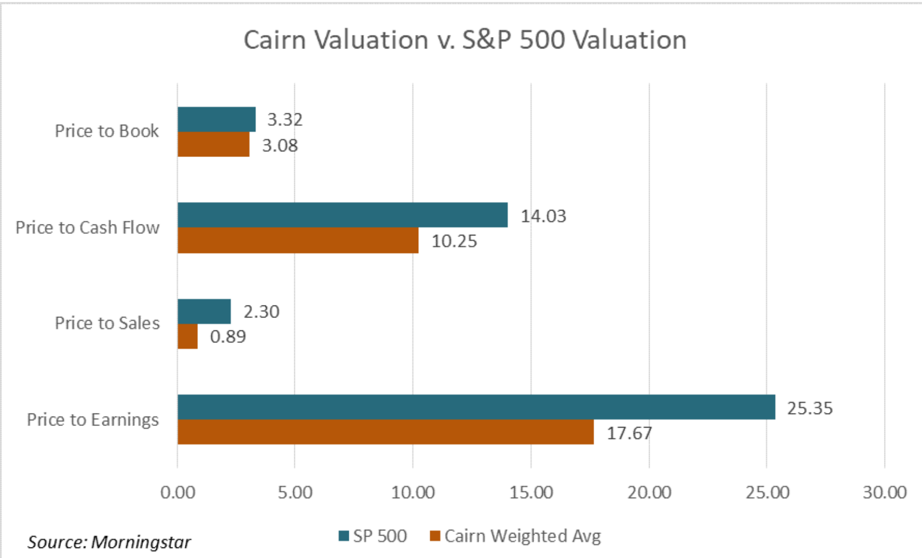
that will eventually take place. The chart below shows the aggregate of the companies we own and how their valuation metrics compare with the S&P 500 Index:



As you can see, by all metrics listed (Book Value, Cash Flow, Sales, and Earnings) your portfolios trade at a lower price than the broader market. We believe our focus on valuation, combined with the patience to wait for value, and a disciplined sell process, will provide satisfactory returns if the market continues to levitate higher, while being prepared for when the market decides it's time for a reversal period. We don't know when that will happen, but we want to be prepared for that inevitable event as we enter year 10 of this market rebound.

My second topic surrounds a new sector in the S&P 500 Index and the reclassification of companies into that new sector. On September 28, the Communication Services sector was created, replacing the Telecommunications sector. The chart opposite shows the changes that took effect and the companies that now make up this new sector. The main takeaway from this change is that the historically "boring" telecom companies such as AT&T and Verizon are going to be included in the same sector as Alphabet (Google), Facebook and Netflix. Needless to say, sector index investors might be in for a much different experience from what they historically had envisioned

Exhibit 1: New S&P 500 Communication Services sector constituents and weights
as of July 6, 2018

Current sector	Ticker	Market cap weight in S&P 500	Market cap weight in New sector	New classification: Sub-industry	New classification: Industry	New classification: Sector
Telecom Services	CTL	0.1 %	0.8 %	Alternative Carriers	Telecom Services	Comm Services
	T	1.0	9.5	Integrated Telecom Services		
	VZ	0.9	8.5			
Consumer Discretionary	OMC	0.1	0.7	Advertising	Media	
	IPG	0.0	0.4			
	CBS	0.1	0.8	Broadcasting		
	DISCA	0.1	0.5			
	CMCSA	0.7	6.2	Cable & Satellite		
	CHTR	0.2	2.3			
	DISH	0.0	0.3			
	NWSA	0.0	0.3	Publishing		
	NFLX	0.8	7.1	Movies & Entertainment	Entertainment	
	DIS	0.7	6.2			
	FOXA	0.3	2.9			
	VIAB	0.0	0.4			
Information Technology	ATVI	0.3	2.3	Interactive Home Entertainment		
	EA	0.2	1.8			
	TTWO	0.1	0.6			
	GOOGL	3.0	27.6	Interactive Media & Services	Interactive Media & Services	
	FB	2.1	19.5			
	TWTR	0.1	1.2			
Cons. Discretionary	TRIP	0.0	0.2			
New Communication Services sector total		10.7 %	100.0 %			

Source: S&P Dow Jones Indices, Goldman Sachs Global Investment Research

investing in some "old school" communication stocks. Though it's not a primary point of emphasis in our company analysis, we do pay attention to index representation in the companies we own so we can try to gain an understanding of what might cause excessive volatility besides company specific events.

In closing, we continue to find good companies that the market has ignored; however, the number is not as plentiful as it was a few years ago. In light of higher than normal valuations in U.S. stocks, we are pleased that opportunities exist, but remain acutely aware that risks are higher than normal. Thank you for your continued trust and please drop me a line if you want to discuss any of these topics in greater detail. —*Patrick Mason*

Thanks, Patrick. Please take him up on his offer to talk about anything related to his analytical work.

Most readers will recognize that it just would not be a Cairn Newsletter if I didn't say "Come on by, the coffee pot is always on."

Happy Trails,

Jim

Jim Parr, Principal
Cairn Investment Group, Inc.