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Market update

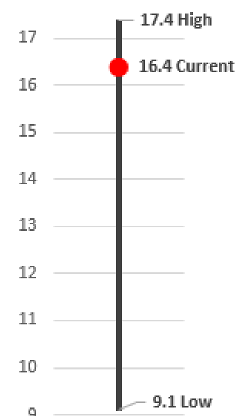
Few market environments are easy to navigate but the environment today provides a particularly interesting combination of factors to manage. Growth globally is modest and inflation in the U.S. is below target levels. As has been noted by commentators ad nauseam, we are also dealing with a market that has been distorted as a result of central bank intervention. Asset prices have been inflated and investors, desperate for return, have stepped out on the risk spectrum to achieve desired/required returns, whether that is to fund their retirement or toward some other purpose.

Reasons to be Optimistic	Reasons to be Pessimistic
• At 5.7% of fund assets, cash levels are the highest since Nov. 2011	• Safe haven assets (gold, treasuries) are signaling fear and warrant caution
• Numerous outlets proclaim this market to be "hated", thus positive data could drive equities higher quickly	• China continues to post mixed econimic results
• The market PE multiple is within its historical range	• Energy prices appear to be trending lower, again
• Housing remains strong, with starts running at a five year high	• Staples, Telecoms, and Utilities are driving the market
• The S&P 500's dividend yield (2.09%) is well above the 10yr Treasury Note's (1.37%)	• US Presidental electoral uncertainty; a Trump victory would likely not be well received by Wall Street
• Jobless claims have remained under 300,000 for 70 straight weeks	• Uncertainty regarding the EU's stability post-Brexit
• To date, 2Q16 earnings are passable with 55% of S&P 500 companies beating expectations	• 2Q16 guidance is poor, with 72% of companies issuing negative guidance and 28% issuing positive guidance
• Federal Reserve monetary policy is accomodative and appears likely to remain so	• S&P earnings are expected to decline for a fifth consecurtive quarter; last occurred in 3Q08-3Q09

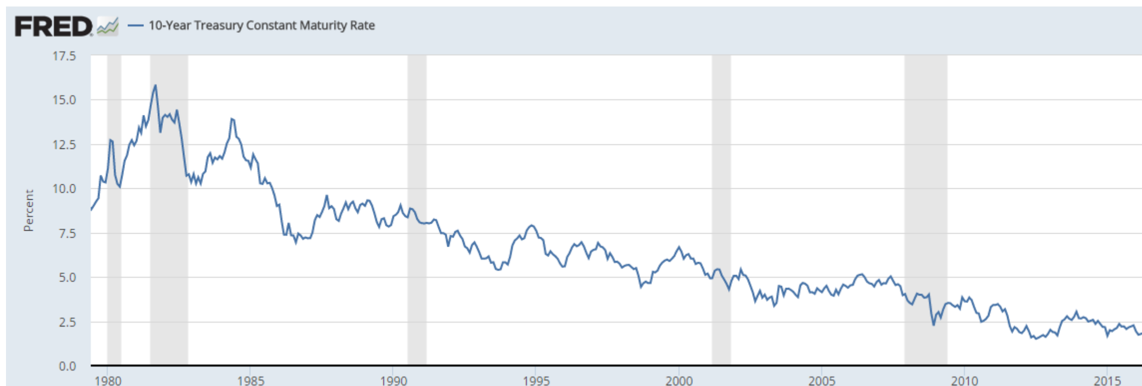
One external factor that has been seemingly removed in the coming months is the chance the Fed may raise interest rates. Coming into the year the Fed indicated they anticipated raising rates four times in 2016. Following the March meeting, it halved the expected number quarter-point rate hikes to two. More recent Fed commentary indicates the Brexit vote and the resulting initial market turmoil has shaken the Fed enough to hold off on rate increases in the near term. Furthermore, we don't believe the Fed wants to hike rates in front of the election in November. Despite the Fed still penciling in two rate hikes this year, the market has rendered its own verdict, anticipating no rate increases in either 2016 or 2017. In coming days we may get

commentary from some of the more hawkish members of the Fed contradicting this belief, but it appears those members of the Fed with the most influence are leaning dovish and we are fairly confident we will see no rate increases prior to the election and likely well beyond that.

Today, markets on a forward 12-month basis are trading at P/E of 16.4x, which while not "cheap" is still reasonable. As we have said in the past, elevated market multiples versus historical levels are easier to justify when returns available from other assets continue to decline. Using the 10-year U.S. Treasury Note as a proxy for returns available from a "risk-free" asset, rates are currently around 1.40%, down from 2.24% at the beginning of the year. This decline in yield on the 10-year treasury is indicative of the slow growth, low inflation environment we are experiencing. Furthermore, with over $11 trillion in global debt offering negative nominal yields, demand for U.S. Treasuries continues to be strong as treasuries are attractive on a relative basis.



To put this in context, if you go back to 1981 the 10-year U.S. treasury yielded over 15.5%. Of course, inflation at the time treasuries peaked was running 8-9%, offering a real yield of ~7%. In 1981, stocks traded at a forward P/E of ~8x, implying an earnings yield of 12.5%. Today, the inflation adjusted return on the 10-year treasury is approximately 0% with a forward earnings yield for the S&P 500 of ~6%. The decline in rates has served as a massive tailwind for stocks for decades. The chart below highlights the historical move in the 10-year treasury yield.



What has the recent decline in yields meant for the markets? Not much. Despite the fact Q2 earnings for the S&P 500 are expected to decline 5.3%, which if true would mark five consecutive quarters of year-over-year declines in earnings (the first time this has happened since 3Q08-3Q09), the market year-to-date is up around 2.5%.

Analysts expect earnings growth to return in the second half of this year, with 3Q16 growth of 0.8% and 4Q16 growth of 7.3%. However, analysts have been consistently too bullish on earnings growth estimates and the trend of revisions in recent years has been lower. The following chart highlights the annual trend of

analyst earnings estimates for the S&P 500 going back to 2014. It is obvious estimates have been overly optimistic and have required downward revisions over time. We will see how the next couple of quarters play out but remain skeptical we break the negative year-over-year earnings trend as currently projected in Q3 of this year.

Despite the poor recent earnings results, money continues to come into stocks due to the poor alternatives available to investors looking for returns. This phenomenon has led to common use of the acronym "TINA", as in, "There is No Alternative" (to stocks with rates so low). The following table highlights yields available on government bonds across the globe.

The Matrix: Race to Negative Bond Yields

Country	1-Year	2-Year	3-Year	4-Year	5-Year	6-Year	7-Year	8-Year	9-Year	10-Year	15-Year	20-Year	30-Year
Switzerland	-1.02	-1.06	-1.10	-1.05	-1.00	-0.91	-0.85	-0.72	-0.63	-0.57	-0.36	-0.21	-0.08
Japan	-0.32	-0.30	-0.29	-0.30	-0.31	-0.31	-0.31	-0.30	-0.27	-0.22	-0.10	0.08	0.14
Germany	-0.61	-0.66	-0.66	-0.64	-0.57	-0.54	-0.46	-0.39	-0.26	-0.13	-0.09	0.11	0.36
Netherlands		-0.60	-0.58	-0.56	-0.42	-0.40	-0.28	-0.16	-0.03	0.09			0.50
Finland	-0.59	-0.58	-0.57	-0.47	-0.42	-0.30	-0.22	-0.10	-0.01	0.15	0.36		0.53
Austria	-0.55	-0.55	-0.50	-0.47	-0.37	-0.32	-0.30	-0.25	0.04	0.21	0.17	0.61	0.85
France	-0.54	-0.55	-0.51	-0.45	-0.35	-0.29	-0.19	-0.08	0.07	0.20	0.51	0.75	0.92
Belgium	-0.57	-0.59	-0.55	-0.51	-0.40	-0.32	-0.22	-0.06	0.09	0.23	0.55	0.62	1.04
Sweden	-0.50	-0.62		-0.49	-0.28		-0.12			0.26		1.14	
Denmark		-0.55			-0.32					0.09			0.45
Ireland	-0.36		-0.26	-0.20		-0.03	0.17	0.31	0.48	0.53	0.84		1.26
Spain	-0.24	-0.17	-0.08	0.05	0.24	0.31	0.54	0.90	1.06	1.23	1.57		2.32
Italy	-0.18	-0.07	0.01	0.13	0.36	0.55	0.74	0.97	1.16	1.34	1.63	1.99	2.36
United States	0.44	0.61	0.71		1.02		1.29			1.48			2.29

Investors forced out on the risk spectrum generally appear to be attempting to hedge their bets by investing in "safe" stocks. This has led to strong year-to-date

performance in utilities, telecom, and consumer staples; names that typically offer attractive dividend yields and sell products that are less discretionary. We have also seen an increase in "low volatility" ETF offerings for investors who are trying to buy stocks as a bond surrogate. Names like Kellogg and General Mills have done well in the current environment despite modest growth prospects and elevated P/E multiples. When a 10-year treasury offers you a 1.5% return, one can see the appeal in buying Kellogg with a dividend yield of ~2.5%. However, buying a company at over 20x forward earnings and modest growth prospects is far from a sure thing, and the risk of capital impairment associated with such a purchase does not approximate the minimal risk associated with buying and holding treasury bonds to maturity.

As we view it, the problem is names like Kellogg and General Mills have been treated as "safe" alternatives to bonds. One thing we have been concerned about in general is names like these getting bought without a full respect for the relatively high price paid or the risks attached. It is one thing to look at a name like Kellogg and determine you are comfortable buying a stock with a current free cash flow yield of ~4.0% (free cash flow is a representation of the cash generation by the company that is available to either be distributed in the form of dividends/buybacks or retained and reinvested by the company) and a dividend payment of 2.5%, and quite another to simply buy a stock because it has a yield that is more attractive than what is offered by many bonds.

Price paid should always be considered in the determination of the riskiness of a stock. We would argue a 4% free cash flow yield is too high a price to pay for a company with Kellogg's profile – a company with low growth and questionable management; however on the more positive side, perhaps they are the next target for Kraft Heinz. Despite the potential as a takeout target, we do not think the risk/reward is properly priced in Kellogg and many similar names.

The concern is these stocks have become in investors' minds something of a bond/stock hybrid, not carrying the full risk of stocks. However, this categorization is a mistake. Because the underlying risk has been miscategorized, a market selloff and the related price action would likely to surprise owners who think they are holding a "safe" asset.

We highlight the current situation in bond/stock hybrid stocks only because we believe it is one place where investors are being pushed out on the risk spectrum without fully understanding the risks. The marketing of ETFs that own names like General Mills and Kellogg's as "low volatility" highlight the fact underlying risks are being glossed over. We are not calling for a doomsday scenario, but activity like this unquestionably makes the market more vulnerable.

A quick note on philosophy

I want to be rich and I want lots of money
I don't care about clever I don't care about funny...

I'll take my clothes off and it will be shameless
Cause everyone knows that's how you get famous – Lily Allen, "The Fear"

The lyrics of English pop star Lily Allen's 2008 hit *The Fear* remind us of the behavior of many market participants. It is only natural, for both the individual investor as well as the professional to disregard the notion of value and simply look to invest in "hot" names without proper analysis of underlying value. We say this is natural because these hot stocks, which seem only to go higher, give the appearance that investing is easy - and who doesn't like easy, immediate returns? How hard is it to simply buy the favored stock of the moment and sit back and watch your investment continue to appreciate? One of the funny things about the market is there is no gatekeeper preventing an investor from buying shares even if they have done limited to no work to understand the company or underlying value.

Sadly, this type of behavior is not confined to the investing home-gamer. More troubling, there are professional money managers who behave this way. Buying the hot stock with no clue as to the true underlying value simply in the interest of improving their standing in the short-term performance derby. Maybe the stock takes off… and they get famous, but we would argue more often than not this type of fame is ephemeral. Investing successfully over extended periods of time without regard for underlying value is next to impossible for most market participants.

Successful investing begins with a firm grasp of underlying value. Buying any stock, because it is "behaving well" and without regard to what it might actually be worth is a very dangerous game to play. It can work in the short run, but as Warren Buffett noted, when the tide goes out it becomes obvious who has been swimming naked. An investor's best chance at long-term investment success is to accurately determine underlying value and acquire the stock at a meaningful discount to that value. Using a value-based approach, it may take more patience to achieve desired returns but ultimately your capital is better protected and we believe your long-term returns also benefit. This is a reminder that Long Lake Capital Management has taken and will continue to place a primary importance on valuation.

Douglas Dynamics (PLOW)

In the second quarter we added Douglas Dynamics to many portfolios. Based in Milwaukee, Douglas Dynamics manufactures snowplows and salt/sand spreaders. The company is relatively small with a market cap of approximately $500 million. Given the nature of their business, it is not surprising the company's results are fairly seasonal and year-to-year results are highly dependent upon snowfall.

PLOW is the leader with 50-60% market share in light duty truck mounted plows, which are sold under the Fisher and Western brands. The company sells their products through an extensive dealer network primarily to professional

snowplowers. PLOW has built a reputation for quality over the past 50+ years and has strong customer loyalty with over 500,000 snowplows and sand/salt spreaders in service. Snowplows typically need to be replaced every 9-12 years and the primary factor in selecting plows is durability and quality, not price. Douglas notches high marks in both the durability and quality categories.

Due the nature of the core snowplow business, management has been working to smooth the seasonality of results via acquisitions. At the end of 2014, the company acquired Henderson, the market leader in the heavy-duty segment of North American snow and ice control, for $92.5 million in cash. Henderson has 20-25% share of the heavy-duty market. Though results for Henderson are also dependent upon snowfall, results are less seasonal with orders coming more evenly throughout the year as a result of the order cycle for the municipal business. Integration to date has gone well and management has highlighted their optimism in achieving further market share gains in the space.

In June, the company made another meaningful acquisition with the purchase of Dejana Truck & Utility Equipment for ~$200 million. This all-cash deal is expected to close in 3Q16. Dejana is a manufacturer of truck attachments and equipment and the acquisition expands PLOW's coverage of trucks to commercial work vehicles (think Comcast work vans). Dejana is also the leading upfitter in the compact work van market, which is growing double digits in the U.S.

Dejana reduces the reliance on snowfall and helps to further mitigate the seasonality of PLOW's business. The price paid for Dejana also looks attractive at a modest 7.1x EBITDA post-synergies. PLOW has done business with Dejana for over 25 years, so the two companies should be reasonably familiar with one another.

Prior to the Dejana deal, we felt the company on a normalized basis could generate free cash flow per share of at least $2.00-$2.25 (trailing twelve month free cash flow per share of $2.50). At a current price of ~$25.50, that equates to a free cash flow yield of ~8% at the low end, which also leaves plenty of room to cover their $0.92 per share annual dividend (3.6% dividend yield). Management has indicated the Dejana deal will be immediately free cash flow accretive. We would not be surprised at all if free cash flow per share exceeds $3.00 once Dejana has been fully integrated. Furthermore, with more consistent, less seasonal results, PLOW may see the market bump up its multiple. Here is hoping for a snowy winter.

Astronics Corp. (ATRO)

Astronics is another new name for many portfolios. The company is a leading supplier of products to the global aerospace, defense, electronics, and semiconductor industries. Astronics operates out of two main segments, Aerospace and Test Systems. The company gets ~80% of its revenue from its Aerospace business, which supplies aircraft lighting, cabin power, and passenger-seat power systems to planes such as the Boeing 737 and 787 and the Airbus A350. The Test Systems business, which designs and manufactures automated test systems for the semiconductor and aerospace and defense markets accounts for ~20% of revenue.

Currently around $32.75 per share, the company is trading well off its 52-week high of $62.29. The weakness has come from two areas. First, there are general concerns about slowing demand in the commercial Aerospace business despite strong growth in the company's key in-seat power business. Second, and the issue most weighing on the stock, is its smaller Test Systems business. In 2015, Apple accounted for 60% of the Test Systems division's sales. Delays on a subsequent Apple order have caused some investors to sell the stock. Astronics anticipates future orders from Apple but has also worked to diversify its customer base and reduce overhead in the division.

Despite the order delays from Apple, management commentary regarding the future of the Test Systems business has actually been very positive, including what they have called an "exciting" 2017. The current headwinds make Astronics a "show me" story for the market and not very attractive for those trying to beat a short-term performance bogey. However, we anticipate the company's near-term challenges will pass and believe our longer-term investment time horizon works to our advantage in situations such as these. If, as expected, the company does regain traction in the Test Systems business, we have been given the opportunity to buy in at an attractive price.

We also have a favorable impression of the management team at Astronics. The company has been forthright about their challenges and what they are doing to face them. Management did the right thing putting in place a $50 million share buyback plan following 4Q15 results to take advantage of weakness in the share price. The repurchase amount represents ~6% of the company's $840 million market cap. In Q1 the company used $4.3 million of the buyback to repurchase approximately 129,000 shares (avg price of around $33/share).

Astronics generates solid returns on capital and even in a year where results are depressed due to the challenges in the Test Systems business and the timing of certain product rollouts, Astronics should generate free cash flow of ~5%. Going forward, we think free cash flow yields can get into the low-double digit range. This name may take some patience, but we believe it has the makings of an appealing long-term investment.

We hope everyone is having an enjoyable summer. If you have any questions, comments or concerns, please do not hesitate to contact us.

Regards,
Bryan & James

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