

MARKET COMMENTARY MONDAY, JANUARY 1, 2018

EXECUTIVE SUMMARY


Happy New Year! - *TPS 615* Coming Wednesday Evening
 2017 Returns Race- Growth Crushes Value
 Russell Index Review - Russell 3000 Value vs. Growth Attribution
 Newsletter Performance - Not Too Shabby Considering No Google, Facebook or Amazon
 Sentiment - What Investors Say Compared to What They Do
 Big Buckingham Pet Peeve - 25 Years to Get Even Following Depression Falsehood
 Investment Lesson - Income Actually Counts
 Target Prices - New Listing Soon to be Posted
 Company News - Updates on NSC, DE, CAT, BHP & HFC

Market Review

Happy New Year! We are already at work on the new edition of *The Prudent Speculator*, with *TPS 615* slated to be available on Wednesday evening, January 3. This month, our *Editor's Note* offers our review of the year just completed and our Graphic Detail takes a look at our newsletter portfolio sector weightings and 2017 performance attribution.

While we could have done without the last 30 minutes or so of trading on the final market day of the year, which sent the major market averages and our portfolios into the red for the week, it is difficult to complain about December. After all, stocks managed to add to their year-to-date gains, with Value-oriented strategies performing modestly better than Growth. The Russell 3000 Value index climbed 1.26% for the month, compared to a 0.76% advance for the Russell 3000 Growth index.

Of course, Growth led the returns race for the full year by a wide margin,...



THE PRUDENT SPECULATOR

Value vs. Growth Returns

Returns Race

2017	2016	Bloomberg	
Return %	Return %	Symbol	Index
28.11	16.50	INDU Index	Dow Jones Industrial Average
29.73	8.97	CCMP Index	NASDAQ Composite Index
21.68	12.04	RIY Index	Russell 1000 Index
14.63	21.28	RTY Index	Russell 2000 Index
21.12	12.72	RAY Index	Russell 3000 Index
21.82	11.95	SPX Index	S&P 500 Index
18.65	10.67	WS000 Index	Wilshire 5000 Total Market
30.21	7.07	RLG Index	Russell 1000 Growth Index
13.64	17.33	RLV Index	Russell 1000 Value Index
22.14	11.28	RUO Index	Russell 2000 Growth Index
7.82	31.72	RUJ Index	Russell 2000 Value Index
29.58	7.38	RAG Index	Russell 3000 Growth Index
13.17	18.38	RAV Index	Russell 3000 Value Index
27.43	6.89	SGX Index	S&P 500 Growth Index
15.35	17.39	SVX Index	S&P 500 Value Index
26.76	4.22	SPXPG Index	S&P 500 Pure Growth Index
17.73	19.62	SPXPV Index	S&P 500 Pure Value Index

Source: Bloomberg

Mutual Fund Benchmarks

Investment Objective	YTD	1-Year	Annualized	
			3-yr	5-yr
Large-Cap Core Funds	20.84	20.29	9.26	14.52
Large-Cap Growth Funds	29.40	28.47	11.07	16.06
Large-Cap Value Funds	15.78	15.47	7.88	13.64
Mid-Cap Core Funds	15.36	14.97	7.78	13.44
Mid-Cap Growth Funds	24.83	24.30	9.08	14.07
Mid-Cap Value Funds	13.26	12.93	7.41	13.30
Small-Cap Core Funds	12.66	12.19	8.42	13.28
Small-Cap Growth Funds	22.69	22.20	9.11	14.13
Small-Cap Value Funds	8.92	8.44	7.46	12.13
Multi-Cap Core Funds	19.36	18.90	8.42	14.16
Multi-Cap Growth Funds	28.28	27.48	10.05	15.23
Multi-Cap Value Funds	15.25	14.91	7.59	13.69
S & P 500 Daily Reinv	21.83	21.27	10.85	16.17

Source: The Wall Street Journal. As of 12/29/17

...with the outperformance primarily attributed to the Information Technology and Consumer Discretionary sectors.

THE PRUDENT SPECULATOR 2017 Russell Value vs. Growth Attribution

Russell 3000 Value vs. Russell 3000 Growth 2017 Attribution									
Sector	% Average Weight			Contribution to Return (%)			Total Return (%)		
Industry Group	R30V	R30G	Δ	R30V	R30G	Δ	R30V	R30G	Δ
Consumer Staples	100.0	100.0	0.0	13.2	29.6	-16.4	13.2	29.6	-16.4
Household & Personal Products	5.2	7.6	-2.4	1.0	1.1	-0.1	12.9	13.9	-1.0
Food & Staples Retailing	2.4	0.9	1.5	0.3	0.2	0.1	13.0	23.7	-10.7
Food, Beverage & Tobacco	1.9	1.5	0.4	0.3	0.0	0.3	16.7	8.3	8.4
Energy	3.9	5.2	-1.3	0.4	0.8	-0.4	9.8	14.4	-4.7
Oil & Gas	11.6	8.7	2.9	-0.4	0.0	-0.4	-21.7	-9.1	-12.6
Energy	11.0	0.7	10.2	-0.4	0.0	-0.4	-1.7	-6.1	7.4
Financials	26.7	3.3	23.4	4.9	1.0	3.9	19.1	29.4	-10.3
Banks	13.3	0.5	12.8	2.4	0.0	2.3	18.6	8.4	10.2
Diversified Financials	8.5	1.9	6.7	1.9	0.7	1.2	23.1	38.6	-15.5
Insurance	4.9	1.0	3.9	0.6	0.2	0.4	13.1	25.1	-11.9
Health Care	11.9	15.3	-3.4	2.0	4.3	-2.4	19.2	26.9	-7.7
Health Care Equipment & Services	4.4	6.4	-2.0	1.0	2.1	-1.0	27.8	31.9	-4.1
Pharmaceuticals, Biotechnology & Life Sciences	7.5	8.9	-1.4	0.9	2.3	-1.3	14.4	23.6	-9.2
Industrials	9.8	12.0	-2.1	1.1	3.7	-2.6	11.2	30.2	-19.0
Capital Goods	7.5	8.2	-0.7	0.7	2.9	-2.2	8.8	35.1	-26.3
Commercial & Professional Services	0.6	1.3	-0.7	0.0	0.2	-0.2	6.9	16.9	-9.9
Transportation	1.8	2.5	-0.7	0.4	0.6	-0.2	22.9	21.5	1.4
Information Technology	9.1	34.6	-25.4	2.3	13.1	-10.8	28.8	40.2	-11.4
Semiconductors & Semiconductor Equipment	2.8	4.2	-1.4	0.9	1.6	-0.6	32.6	42.6	-10.0
Software & Services	2.7	23.0	-20.3	0.6	8.5	-7.9	24.0	38.5	-14.5
Technology Hardware & Equipment	3.6	7.4	-3.8	0.9	3.0	-2.1	25.8	44.7	-18.9
Materials	2.6	3.9	-1.2	0.6	0.9	-0.3	21.0	23.4	-2.4
Metals & Mining	2.6	3.8	-1.2	0.6	0.9	-0.3	21.0	23.4	-2.4
Real Estate	5.2	2.8	2.5	0.2	0.5	-0.3	4.8	18.4	-13.6
Real Estate	5.2	2.8	2.5	0.2	0.5	-0.3	4.8	18.4	-13.6
Telecommunication Services	3.1	1.0	2.1	-0.2	0.1	-0.2	-3.5	7.5	-11.0
Utilities	6.3	0.1	6.2	0.8	0.0	0.8	12.4	22.9	-10.5
Utilities	6.3	0.1	6.2	0.8	0.0	0.8	12.4	22.9	-10.5
Consumer Discretionary	8.0	19.0	-10.9	0.9	4.9	-4.0	13.6	25.4	-11.8
Automobiles & Components	1.1	0.9	0.2	0.2	0.3	-0.1	17.5	30.6	-13.1
Consumer Durables & Apparel	1.0	1.8	-0.8	0.2	0.4	-0.3	20.3	25.5	-5.1
Consumer Services	0.9	3.6	-2.7	0.3	1.1	-0.8	28.6	31.9	-3.3
Media	1.7	4.1	-2.5	0.1	0.4	-0.3	10.4	8.0	2.4
Retailing	1.4	8.6	-7.2	0.1	2.7	-2.6	5.1	31.6	-26.5

Value Stocks struggled mightily relative to Growth in 2017, with 1640 basis points of total under-performance from a contribution to return perspective. Info Tech (1080 basis points), Consumer Discretionary (400 basis points) and Health Care (240 basis points) were the culprits.

Still, we really cannot complain too much about our 2017 newsletter portfolio returns in the 17% to 20% range, despite the 21% return for the Russell 3000 benchmark, especially given our lack of exposure to top-performing expensive names that a Value approach would not be expected to hold. Believe it or not, big Info Tech companies Alphabet (aka Google) with a two-class-combined 70 basis point contribution to total return, Facebook (62 bps) and Visa (30 bps), as well as Consumer Discretionary titan Amazon (72 bps), account for most, if not all, of our return gap versus the Russell 3000. Of course, we are very comfortable, given that the markets are trading at record levels, with the relatively inexpensive valuation metrics and attractive dividend yields of our portfolios.

THE PRUDENT SPECULATOR Equity Strategies & Benchmark Metrics

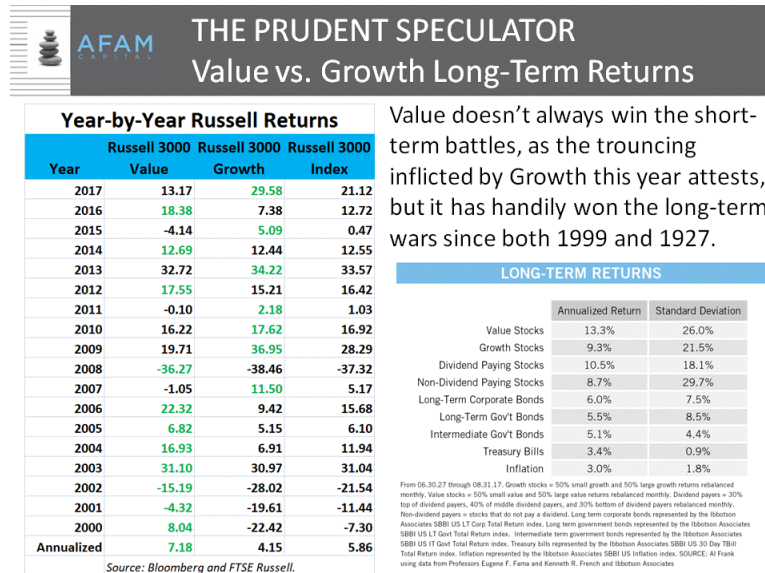
CURRENT PORTFOLIO AND INDEX VALUATIONS

Name	Price to Earnings Ratio	Price to Fwd. Earnings Ratio	Price to Sales Ratio	Price to Book Ratio	Dividend Yield
TPS Portfolio	16.8	14.4	1.2	1.9	2.6
Buckingham	17.3	14.8	1.2	2.0	2.4
Milenium	17.7	14.8	1.3	1.9	2.5
Prufolio	17.6	14.9	1.2	2.0	2.4
Russell 3000	24.1	21.1	2.1	3.1	1.8
Russell 3000 Growth	28.7	23.9	2.8	6.4	1.3
Russell 3000 Value	20.7	18.8	1.6	2.1	2.4
Russell 2000	57.0	34.7	1.3	2.4	1.4
Russell 2000 Growth	102.9	46.5	1.6	4.5	0.7
Russell 2000 Value	38.4	27.2	1.0	1.6	2.0
Russell 1000	23.0	20.4	2.2	3.2	1.8
Russell 1000 Growth	27.0	23.0	2.9	6.7	1.3
Russell 1000 Value	20.0	18.3	1.7	2.1	2.4
S&P 500 Index	22.5	20.0	2.2	3.3	1.9
S&P 500 Growth Index	26.0	22.2	3.6	5.8	1.3
S&P 500 Value Index	19.7	18.1	1.6	2.3	2.5
S&P 500 Pure Value Index	15.6	14.3	0.7	1.5	3.2

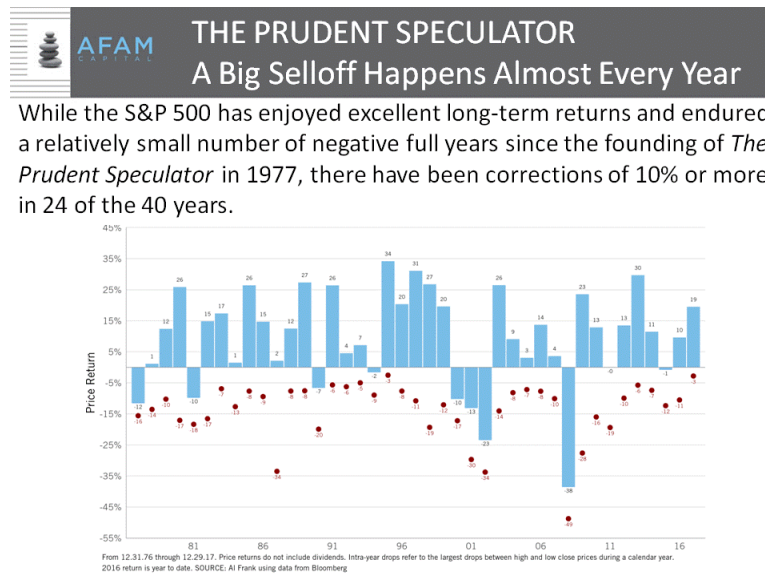
As of 12.30.17. Weights based on model portfolios. Harmonic mean used to calculate the portfolio price metrics. Companies with negative earnings are excluded from the P/E and Estimated P/E calculations. SOURCE: AI Frank using data from Bloomberg

Certainly, we understand that there will be those who see greener grass and are disappointed by performance in the 17% to 20% range, even as just about everyone at the start of the year would have been thrilled if told that their portfolio would enjoy such historically outsized returns in 2017. But we hope that perspective can be had by considering that Value doesn't always win

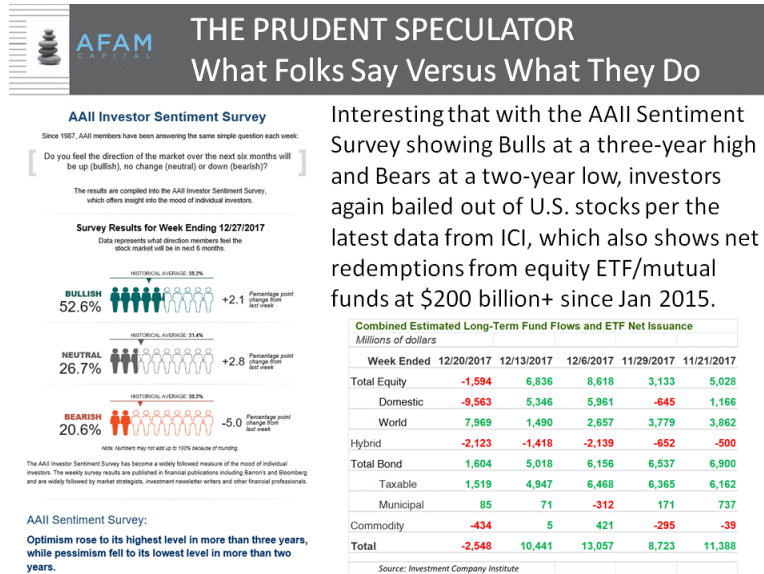
the short-term competition, but it has convincingly won the long-term performance derby by a wide margin.



We shall see if the late-Friday selloff is a precursor to more profit-taking when trading resumes in 2018, and we are always prepared for the inevitable downturns,...

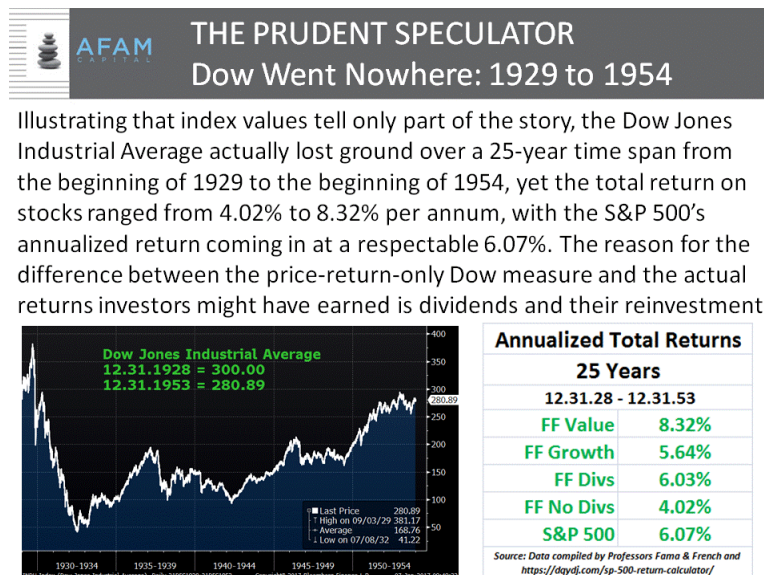


...but we are optimistic in our outlook for 2018 and beyond, given healthy corporate balance sheets and income statements (both of which are likely to be bolstered by the Tax Cuts and Jobs Act), in addition to the solid domestic and global economic backdrop, the low interest rate environment and the fact that investors are not yet overly optimistic in terms of what they are actually doing with their money.



We also cannot forget that the kinds of stocks that we have long favored have returned 10% to 13% per annum on average over the last nine decades, so we think the odds are in favor of the long-term-oriented Dividend Value investor, which is why it bothers your editor greatly when supposed market experts utilize spurious arguments to attempt to scare folks into abandoning equities or reducing their exposure.

Certainly, there is no shortage of very real things to worry about – geopolitics, terrorism, low volatility, high valuations relative to history, two terrific back-to-back years and Washington – and those with a short-term time horizon should tread very carefully, but last week another very well respected market pundit put forth the false assertion that it took 25 years to get even following the Great Depression. To be fair, he wasn't suggesting that investors should dump stocks, but we remain stunned that so many investment professionals continue to accept this non-truth as the gospel.



We are amazed that seemingly bright commentators don't understand that the market averages exclude dividends from their numerical calculations as the S&P 500 gained over 6% PER ANNUM for the 25 years from 1928 to 1953, even as the Dow Jones Industrial Average dropped from 300.00 to 280.89. Historically speaking, dividends and the impact of their reinvestment have accounted for 30% to 40% of total return, so it is foolish to ignore them when talking about investment returns.

Alas, we have been trying to educate investors on this subject for quite some time, so we still have work to do, but we struggle to understand, for example, how the supposed experts on Wall Street could ever justify including bonds in an asset allocation mix with their price return logic. After all, if dividends don't count when it comes to stock returns, interest payments shouldn't count with fixed income securities.

As Morningstar pointed out in their 2015 Ibbotson SBBI Market Report, the capital appreciation component for Long-Term U.S. Government Bonds saw \$1.00 invested in 1925 grow to a whopping \$1.437 by the end of 2014 for a return of 43.7% in 89 years, or an annualized 0.41%. As the chart earlier in this missive shows, LT Gov't Bonds actually have returned 5.5% per annum, including interest payments and capital appreciation, meaning that income is hardly immaterial!

Stock Updates

We have remained content of late with the current composition of our broadly diversified portfolios, but it is becoming more difficult to hold tight to all of our holdings as many stocks have posted solid gains and/or valuations have become less attractive. We are in the process of posting a new Target Price listing to theprudentpeculator.com, while Jason Clark provides a brief update below on three of our industrial holdings that enjoyed sensational returns in 2017 and Chris Quigley looks at two other of our stocks that have neared or eclipsed previously published fair valuation figures.

Norfolk Southern (NSC - \$144.90), 37% total return in '17, **Deere & Co.** (DE - \$156.51), up almost 55%, and **Caterpillar** (CAT - \$157.58), up 75%, are three names that we have decided to continue to hold onto as we begin 2018. That said, while we feel there is enough reason to push our Target Prices up a bit, we always reserve the right to trim these positions or part ways with them in their entirety if an opportunity with a more appealing risk/reward profile presents itself, or if new news alters our thesis, or if the valuation hits a level that no longer justifies a hold.

While Norfolk Southern has had to continue to deal with strong headwinds in coal shipping, the railroad operator has benefitted from increased intermodal volumes over the past 10 years (as intermodal revenue surpassed coal revenue a few years ago). We think this trend will continue and we believe that NSC will benefit in 2018 from recent capacity and speed improvements, changes the company is making to meet its goal of getting its operating ratio below 65% by 2020, and greater carloads from stronger industrial production activity and tightening truck capacity. Additionally, with tax reform now passed in the U.S. (Norfolk has been paying an effective rate north of 30%), we would not be surprised to see Capitol Hill turn its attention to national infrastructure improvements that would seemingly bring a boost to NSC's business. While shares are currently trading a bit above 22 times NTM adjusted earnings projections of

\$6.47, forecasts for 2019 and 2020 adjusted EPS are currently pegged at \$7.80 and \$9.28, respectively. Norfolk is set to report Q4 results on January 24, which will give us new information to consider, but until then we have slightly boosted our Target Price to \$152.

While shares of Deere enjoyed another strong year of returns, we do not believe the opportunity is over yet for the farm equipment maker. We remain optimistic about the long-term potential of global agriculture in general, as the decline of global arable land and population growth should force farmers to be more productive and should continue to drive demand for more efficient farming. While DE won't report the latest quarter's results until mid-February, we have been pleased to see its recent momentum in sales and note that the company is forecasting 9% growth in Ag & Turf Equipment, including a 2% benefit from currency translation. In the U.S., Deere expects "significant growth" to be driven by smaller Ag & Turf products, due in part to new product launches in 2018. Additionally, in the U.S., we believe that Deere could benefit from the newly signed tax bill as a number of its customers may enjoy more capital from lowered taxes as well as the ability to immediately expense some "shorter-lived" capital investments. While DE shares are currently trading at 19 times 2018 consensus earnings estimates, analysts are now projecting 2019 and 2020 adjusted EPS to be \$9.68 and \$10.88, respectively. Our new Target Price for DE, which has paid an effective tax rate in the 29% range the last two quarters, is \$164.

Finally, machinery manufacturer Caterpillar massively surprised the naysayers in 2017 with its impressive share price gains. While we seemingly were in the minority of those that liked the long-term prospects for Caterpillar as we exited the financial crisis, staying the course through the "tough times" eventually proved very prosperous as numerous Wall Street analysts, influential investors and market pundits jumped on the CAT bandwagon last year. While valuation metrics are now at the upper end of our comfort zone, with CAT trading at 24.5 times adjusted EPS projections for 2018, investors see 2019 and 2020 earnings coming in at \$9.24 and \$9.74, respectively, lowering the forward P/E ratio considerably. As with Deere, we believe that CAT will not only benefit from domestic tax cuts (the effective tax-rate was 31% the last three quarters), we think that they will also profit from some of its clientele being able to immediately expense capital investments and the potential for increased infrastructure spending in the United States. As we recently wrote, we are also encouraged by recent worldwide machinery sales reports for CAT, especially a turnaround in Latin America. In addition to the potential here at home, we still see attractive long-term opportunity within emerging economies. That said, while we remain long-term fans of the company and we are choosing to bulldoze ahead with our shares, we are keeping close watch on CAT and its increased valuation, especially as the stock is a long way removed from the Wall Street dog house. Our Target Price has been lifted to \$162.

Commodity prices generally climbed in 2017, helping Australian natural resource giant **BHP Billiton** (BHP – \$45.99) reach levels not seen since the middle of 2015. And, after a profitable fiscal 2017 (ended June), earning an adjusted \$2.64 per share, and estimates for fiscal 2018 hovering around \$2.94, we think that the wave of momentum is worth riding a little longer. Our Target Price is now \$49.

We continue to like BHP's diversified mining operations that extract different metals and ores and we think that its significant investments during a difficult operating environment should pay off in the future. BHP Minerals Australia President, Mike Henry, said in November, "The quality, scale, concentration and location of our assets support improvement initiatives, compelling latent capacity options, efficient technology deployment and attractive investment opportunities. By sharing knowledge and replicating best practice across our global portfolio, we've been able to substantially reduce unit costs at our Australian mining operations over the last five years. But we have further to go. We can make ourselves safer and even more productive, and expect to lower our unit costs by a further 10 percent over the medium-term."

While the Materials sector has encountered a very difficult operating environment over the past few years, with BHP no exception to the trend (though BHP did outpace the S&P Materials index in 2017 by 10%), we think that the company has put much of its painful restructuring in the rearview mirror. We certainly remember that BHP earned in excess of \$4 per share every year from 2006 to 2014 with lots of commodity price volatility during that time span, and think the company can return to its historical levels of operational success in the future. However, despite our long-term optimism for the prospects of the business, and our affection for the 3.7% current dividend yield, we can't deny that the stock is becoming expensive, so we always reserve the right to sell, especially if a better opportunity emerges.

Shares of **HollyFrontier** (HFC – \$51.22) had a terrific 2017, climbing more than 63% including dividends, as a result of more favorable refining margins. As a result, the refining and marketing company has beaten analyst EPS estimates for the last five quarters, and we think that the momentum may continue when the company reports Q4 results on February 21.

For 2018, we think that weakening EPA requirements may prove beneficial to HFC, as the company is a net buyer of Renewable Fuel Standard (RFS) blending credits. While there are potential benefits, we aren't banking on a specific outcome because challenges to the Obama Administration's blending targets continue to be hashed out in the court system.

At HFC's analyst day in December, CEO George Damiris offered details on the company's Specialty Lubricants business, which Mr. Damiris said is often not understood by investors. The company values the operating segment at \$2 billion because of its stable, high margins (\$200 million of EBITDA per year times 10, compared with the company's \$9 billion market capitalization). Mr. Damiris said, "Specialty lubricants is basically two businesses in one. The first business is base oil production, converting gas oils to base oil, or what we call rack back. The rack back business is basically similar to refining. The real value is created in the second business. Formulating those base oils, the finished lubricants and specialty products, are what we call rack forward. This may sound easy but it is not. It is technology and intellectual know-how-driven that requires manufacturing, R&D, sales and marketing capabilities to identify customer needs and customize solutions to satisfy these needs."

Mr Damiris added, "We will continue to look to grow our company. We believe growth is important because scale is important. We believe scale is important because the capital markets, both debt and equity, tell us scale is important. Our industry tells us scale is important as it consolidates. Our competitors continue to get bigger. The talent market also tells us scale

is important. We've attracted talent at HollyFrontier that neither Holly nor Frontier could have been able to attract as two or three refinery companies. Having said all that, we will continue to be very disciplined. Maintaining our investment grade rating is very important to us. We will not grow simply for growth's sake. It has to be a good deal where we can bring something to the acquisition, and the acquisition can bring something back to us. We believe our track record speaks for itself from Tulsa through PCLI who's acquired great companies, quality businesses at good prices. We look forward to continue business growth into the future."

Though the company has a sizable amount of long-term debt (\$2.24 billion) at last count, we like that HollyFrontier has a decent balance sheet and has kept costs under control during this period of recovery. Analysts project a strong rebound for Holly, with respective EPS estimates of \$3.05, \$3.37 and \$4.67 for 2018, 2019 and 2020, respectively. Despite our long-term optimism for the prospects of the business, we can't deny that the stock is becoming expensive and has a weakening score in our proprietary valuation engine, so we certainly could see ourselves taking a little money off of the table in the not-too-distant future. For now, our revised Target Price is \$55, and we note that HFC still yields a solid 2.6%.

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