

# HENDERSHOT INVESTMENTS

Dec. 2014

EDITOR: INGRID R. HENDERSHOT, CFA

1994-2014

## TWENTY YEAR ANNIVERSARY SPECIAL EDITION!

This issue marks twenty years of Hendershot Investments providing investment advice to our clients and the publication of this newsletter. Over this period, we have strived to provide our readers insightful market observations and long-term investment principles in an easy to understand format. This special edition looks back over the last twenty years at many of the feature articles appearing in each quarterly newsletter, as we addressed the events in the world and how we applied our investment philosophy during these times to build wealth through the ups and downs of the economy. We hope you enjoy this retrospective of the past 20 years.

**DECEMBER 1994:** The initial publication of *Hendershot Investments* outlined our investment philosophy and started to build our investment portfolio with 20 stocks for the new year. Twenty years later, we still currently hold four of the original 20 stocks, which demonstrates our truly long-term investment time horizon.

The **MARCH 1995** issue featured the article *Record Share Buybacks Bullish For The Future*. While a plethora of pessimists proclaimed the stock market was overvalued, Corporate America was following the game plan from the post-October 1987 crash playbook and busily buying back shares at a record pace. In 1987, these purchases allowed management to scoop up shares at depressed prices and to reap the benefits as the market doubled over the next seven years. We asked, "Are savvy investors rapidly repurchasing record amounts of their shares today in anticipation of an 8000 Dow following the turn of the century?"

**JUNE 1995** featured our first article on the benefits of investing in *HI*-quality stocks that paid and increased their dividends over time. Meanwhile, our **SEPTEMBER 1995** issue set out one of our crucial investment rules, "Don't overpay for a stock."

We cautioned about inflated technology valuations during the dot-com era. Technology stocks with little revenue and no profits were being

valued on the number of eyeballs viewing a website, a valuation measure that deserved a hairy eyeball!

In our **JUNE 1996** issue, *Record Results, Year After Year*, we reminded investors that they should keep in mind the fable of the tortoise and the hare when selecting long-term investments. We wrote, "Racy, glamour stocks which quickly jump to big initial gains may tempt you. Over the long term, these 'hot' investments often evolve into harebrained holdings.

In fable lore, the bustling bunny poops out and becomes a hapless hare long before the investment race is over." We noted our preference "to bet on tenacious tortoise stocks...those companies which deliver steady growth no matter what the economic climate."

In **DECEMBER 1996**, after Berkshire Hathaway had acquired FlightSafety International, one of our original investments, we identified a few of our companies that would fit Berkshire Hathaway's investment criteria in an article titled *Warren Buffett Might Like These Stocks Too!*

With a long-term perspective, we noted Mr. Buffett's penchant for identifying solid companies, like FlightSafety, and buying them when the stocks were selling at a

discount to their underlying intrinsic value. Following this model, we identified several other stocks in the *HI* portfolio that might also catch the eye of the Oracle of Omaha because of their tempting valuation levels. Aware of Mr. Buffett's fondness for sweets as evident by his daily Cherry Coke cravings, we suggested that Tootsie Roll and Dairy Queen might also satisfy his sweet tooth. (Note: International Dairy Queen, which we owned in the *HI* portfolio, was indeed acquired by Berkshire Hathaway two years later in January 1998.)

**JUNE 1997** featured a review of the first of our 17 visits to the Berkshire Hathaway annual meeting in Omaha, Nebraska, with a summary of the wise lessons learned from Mr. Buffett and his business partner, Charlie Munger. This report would become a regular June feature following the meeting held in May each year.

The **DECEMBER 1997** issue had us discussing a recurring topic of buying stocks on sale in the article, *When Mr. Market Behaves Irrationally....* We wrote, "Mr. Market is an excitable chap! He is subject to alternate bouts of depression and 'irrational exuberance,' a well-known phrase coined by Alan Greenspan, the Federal Reserve Chairman. The month of October for some reason always

seems to bring out the worst in Mr. Market, and this past October was no exception.

After suffering from the Hong Kong flu, Mr. Market woke up on Oct. 27, 1997, in a downright despondent mood. He indiscriminately sold stocks, driving the market down in its biggest point decline ever. The next day Mr. Market realized he had been a bit rash and bought back the very stocks he had sold the day before. On record volume of more than one billion shares, the market rebounded with the biggest point gain ever. Irrational behavior? You bet!"

**MARCH 1998** featured another *HI* investment principle in the article, ***Cash-Rich And Debt-Free Provides Opportunity*** where we identified some of our favorite investments, companies that are cash-rich and debt-free. We observed that financially strong firms have inherent competitive advantages, which are especially noticeable in market downturns. Companies, which consistently generate strong free cash flows with little debt, generally provide superior shareholder returns.

In **MARCH 1999**, we explained the value of long-term investing in the article, ***The Rip Van Winkle Approach To Investing***, citing Warren Buffett's philosophy that, "If you aren't willing to own a stock for 10 years, don't even think about owning it for 10 minutes." The Rip Van Winkle approach starts by identifying *HI*-quality companies with consistent, long-term growth records, high returns on equity and strong balance sheets. By investing in these stocks when valuations are reasonable, investors may then take a long nap and completely ignore the daily rumblings and inevitable crashes of the market. They will then wake up and happily find their wealth is significantly greater than when they began their hibernation. Using Mr. Buffett's company, Berkshire Hathaway, as an example, investors over the years have been counting money bags

instead of sheep in their sleep. We wrote, "If before going to sleep you placed an initial investment of \$10,000 in Berkshire stock in 1965, you would wake up today with **more than \$50 million!** Few people recognize that Mr. Buffett, the second-richest man in the world, actually is Rip Van Winkle! (Buffett keeps his disguise intact by regularly shaving off his long beard with razors manufactured by Gillette, a holding of Berkshire.) As simply stated by Mr. Buffett himself, 'We continue to make more money when snoring than when active.' "

As the dot-com bubble began to burst, we featured articles discussing the valuation and price of these high-flyers. Our **DECEMBER 1999** article, ***Which Internet Emperor Is Really Wearing Clothes?*** perhaps best described the tumble of these stocks. Our story began as follows:

"Once upon a time in Internet land, vast empires dot-commed the landscape. These tulip-filled empires stretched from the mighty Amazon to the great Ebay. Each time a new Internet emperor was born through an initial public offering, Mr. Market poured himself a glass of bubbly to celebrate and giddily bestowed upon new emperors royal riches...by doubling or tripling the stocks of the fledgling empires.

Soon Internet emperors were popping up everywhere, and Mr. Market decided to throw a grand party. The Internet emperors realized this might be their final chance to obtain further riches from the woozy Mr. Market so they all shopped for the finest party clothes. Unfortunately, many emperors had empires which generated little sales and no profits. Alas, these poor Internet emperors had no money for clothes. Since no one, so far,

had seemed to notice their bare cupboards, they proudly paraded to the party anyway with high hopes and little else to show. Mr. Market threw an exuberant party with bubbly flowing freely from a seemingly endless fountain. When the party finally ended, Mr. Market woke up with a dreadful hangover and vowed, "No more bubbly!"

Once Mr. Market sobered up, he was surprised to discover so many Internet emperors wearing no clothes! Just then a gigantic balloon, hanging over the bubbly fountain, popped! The emperors tried valiantly to catch a fragment of the balloon to cover up their deficiencies. However, most of the em-bar-assed emperors just streaked away, and their tulip-filled empires disappeared almost as quickly...never to be seen again.

**Moral of the story:** Before investing in Internet stocks, determine which Internet emperor is really wearing clothes. Otherwise, you'll likely end up with a barren asset!"

In **MARCH 2000**, our feature article ***How Can You Tell When It Is Time To Sell?*** provided insights into our selling strategies as we rebalanced our portfolio from high-flying technology stocks into unloved "old economy" stocks. We wrote: "As Philip Fisher said in *Common Stocks and Uncommon Profits*, 'If the job has been done correctly when a common stock is purchased, the time to sell it is -almost never.'

There are times, however, when prices race far ahead of business values due to Mr. Market's "irrational exuberance" about future business prospects such as with technology and biotechnology stocks. You will note that we take partial profits then. At the same time, there are many stocks which appear undervalued and offer very attractive buying opportunities. Rebalancing the portfolio by trimming back stocks that appear overvalued and reinvesting the

proceeds into undervalued stocks should create future long-term gains while reducing overall portfolio risk.”

As market volatility returned, both the **SEPTEMBER** and **DECEMBER 2000** issues addressed valuation of stocks. In *The Voting Machine VS The Weighing Machine*, we noted the sage advice of Ben Graham, the father of value investing, who wrote in *Security Analysis*, “The market is not a weighing machine on which the value of each issue is recorded by an exact and impersonal mechanism in accordance with its specific qualities. Rather, it should be said that the market is a voting machine, whereon countless individuals register choices which are the product partly of reason and partly of emotion. The disciplined, rational investor neither follows popular choice nor plays market swings; rather he searches for stocks selling below intrinsic value and waits for the market to recognize and correct its errors. It invariably does and share price climbs. When the price has risen to the actual value of the company, it is time to take profits which then are reinvested in a new undervalued security.” (It was with Graham’s wise words in mind that we rebalanced the **HI** portfolio earlier that year on March 10, 2000. As it turned out, this date was the exact peak of the NASDAQ index.)

We pointed out that the tech stocks that were trimmed back on 3/10/00 had declined on average 36%, while the stocks purchased with the proceeds had gained an average 105%. While some thought Ben Graham’s weighing machine may have turned rusty in the “new era,” our conclusion was that it was as trusty as ever!

Following the tragic events of Sept. 11, 2001, the **DECEMBER 2001** issue featured advice on investing during troubled times in the article *Investing In Stocks Despite External Shocks*. We wrote, “No one will ever forget the terrible tragedy of Sept. 11, 2001. The world watched in horrified shock as the

World Trade Center towers collapsed, the Pentagon burned and a plane in Pennsylvania perished.

Following the attack, the stock market remained closed for four days, the longest period since the Great Depression. When trading resumed, the stock market suffered one of the worst weekly declines in decades due to external shocks. As prices tumbled during the September sell-off, it was apparent that stock prices were declining much more than the underlying values of businesses. Most **HI**-quality companies recognized this discrepancy and repurchased their shares.”

Relying on our valuation principles, we observed that despite external shocks, investing in **HI**-quality companies made sense if purchased at a reasonable value. While it is without doubt that we will witness further shocks in the future, we maintained that a calm assessment of individual business values often provides good investment opportunities. We took comfort in the words of Mr. Buffett who stated shortly after the terror attacks, “There is nothing dumber than betting against America. It hasn’t worked since 1776.”

The next year resulted in more tumultuous times. Our **SEPTEMBER 2002** feature article, *Goldilocks And The Three Bears*, used the well-known fairy tale to illustrate the hazards of failing to recognize changing market conditions. We compared unwise investors to the porridge-thieving Goldilocks, falling asleep with the NASDAQ, DOW and RUSSELL indices at or near record levels. Like Goldilocks, these investors slept as the world changed dramatically.

A recession, terrorist attacks, the threat of nuclear war, Mideast tensions, a complete breakdown

in corporate governance and a lack of accounting integrity among several public companies brought out the bears.

These grizzly bears clawed the stock market to shreds with the three stock indices suffering losses of 25% to 70%. Just as Goldilocks scurried from the bears upon their return home, so, too, did investors hightail it out of the stock market.

Unfortunately, this fairy tale had a sad ending with investors scared out of the market right at the time when many stock valuations once again became “just right.”

As we noted, long-term investors have learned that when the bears come marching into town, playing their accordions, each squeeze of the accordion compresses valuation multiples. However, they have also learned that the bears play oom-pa-pa music when it comes to **HI**-quality companies. As stock prices are squeezed lower, valuations become much more attractive for businesses that continue to generate steady profitable growth and possess strong balance sheets. While we did not predict when the bears would hibernate again, we remained confident that buying **HI**-quality companies in difficult times would lead to happy endings after all!

The **MARCH 2003** article, *When Insiders Buy, Investors Should Ask Why*, chronicled the insider purchases made in Brown Forman, Home Depot and Kimberly Clark.

After three years of a bitter bear market, many investors were tempted to throw in the towel. On the other hand, towel-wrapped corporate executives were coming out of the sauna looking for their wallets. We noted that in the prior quarter, insiders in these three **HI**-quality companies recognized the attractive valuations and bought shares in their companies. We suggested that when insiders buy, investors should ask why. The answer often leads to rewarding results.

Our **MARCH 2004** article, *When There Is A Bull In The China Shop...* addressed investing in China. The Chinese stock market had risen a blistering 81% in 2003. Initial public offerings were hotter than a steaming cup of Chinese tea. However, we observed that when there is a bull in the China shop, investors should be wary. We suggested that the best way to benefit from China's growth is through investments in *HI*-quality companies that were successfully doing business in China. We identified a number of *HI*-quality companies with active participation in the Chinese market as a way to invest in the growing Chinese economy. We concluded, "As a Chinese fortune cookie might say: When there is a bull in the China shop, beware of bubbles that will pop. Instead, get rich slowly with *HI*-quality investments."

In **JUNE 2004**, our article, *The Best Since 2000*, noted that with the return of pricing power, *HI*-quality companies were reporting the best earnings since 2000. On the other hand, Mr. Market was now fretting over bubbling oil prices and the three "I's" - inflation, interest rates and Iraq. Favorable economic news was battling with concerns over inflation—resulting in a tug-of-war which would pull the DOW back and forth over the 10,000 line for the summer. We noted that this volatility could provide buying opportunities for the long-term investor.

In **SEPTEMBER 2004**, several *HI*-quality companies were identified in *When There Is A Market Drop, Good Values Pop Up!* where we noted that while market downturns may be disconcerting, long-term investors view market corrections as a buying opportunity. A combination of lower stock prices and higher earnings results in more reasonable valuations. With this latest market drop, good values did pop up again among many *HI*-quality enterprises. These good companies with good management teams were once again selling at good prices which should

reward investors with gold-medal results over the long term!

In **MARCH 2005** our feature article proclaimed *Dividends, Dividends, Dividends!* During the previous year, companies in the S&P 500 index had paid out over \$181 billion in dividends, a figure which did not include the \$32.6 billion special dividend paid by Microsoft. Another record year was projected by S&P for 2005, with dividends expected to grow 12% to more than \$200 billion. We wrote:

"Despite the record levels of dividends, Corporate America has plenty of runway to increase dividends further as S&P 500 firms only paid out 34% of profits last year, which was below the historical 54% payout ratio. A rising dividend payout portended good news for future earnings growth." A study by Asness and Arnott in the *Financial Analyst Journal* the previous year found that when dividend payouts are high—signaling management's confidence in the future—solid earnings growth lies ahead.

We observed that dividends have historically accounted for about 40% of the total return of the stock market. With strong dividend payouts in 2004 and in early 2005, the trend of dividend-paying stocks outperforming non-dividend-paying stocks was likely to continue. We further believed *HI*-quality dividend-paying stocks would fare even better.

Our **JUNE 2005** article, *The Best Time To Make Hay Is When The Skies Are Gray* noted that the market continued to provide good investment opportunities as we stated: "Gray clouds have been hovering over the stock market all year. Mr. Market has been fretting about oil prices, interest rates, slower economic growth, junk bond jitters and potential hedge fund

hurricanes. These worries drove stock prices lower with many *HI*-quality companies now on sale."

We observed that long-term investors knew that the best time to make hay is when the skies are gray. By looking past the clouds and acquiring *HI*-quality companies at reasonable prices, future investment returns were likely to be bright.

We returned to the dividend theme in our **DECEMBER 2005** article, *Betting On The Big Blue Chips*. We explained that a "blue-chip" is a stock of a well-established and financially sound company that has demonstrated its ability to pay dividends in both good and bad times. According to this definition, Johnson & Johnson, 3M, Wal-Mart and ExxonMobil qualified as blue-chip blue bloods. All of these firms had paid dividends for decades with ExxonMobil paying a dividend every year for more than a century. We suggested that long-term investors seeking a deal should belly up to the table and place their bets on the big blue-chip stocks.

*Patience And Discipline: The Keys To Successful Investing* appeared in our **JUNE 2006** issue at a time when this did not seem an apparently successful approach to wealth building. We wrote:

"During the past couple of years, *HI*-quality investing hasn't appeared to be working as investors chase 'hot' investments like 'com'modities. The last time 'com' was so popular, it wasn't a prefix but a suffix found in dot-'com.' The out'com'e will likely be the same.

During the dandy dot-com party, the clock struck midnight on March 10, 2000, with the NASDAQ index peaking over 5000 while the "old economy" firms like Berkshire Hathaway were hitting their yearly lows. Six years later, the dreadful dot-com hangover endures with the NASDAQ still down more than 50% while patient investors, who held

onto *HI*-quality stocks like Brown-Forman, Clorox, Fastenal, Genuine Parts and Berkshire Hathaway, had seen those stock prices more than double in value."

We stressed that disciplined investors don't get carried away by Mr. Market's emotions, but rather patiently buy and sell investments based on underlying business fundamentals. We compared our approach to that of hedge fund manager and investor Joel Greenblatt, who in his 2005 work *The Little Book that Beats the Market* coined the phrase "Magic Formula investing." His approach of value investing stressed our two favorite concepts—good company and good price. Just as importantly, Greenblatt counseled patience and discipline in sticking with this investment strategy even when it doesn't appear to be working.

The **MARCH 2007** issue, *What Do You Know, Another LBO?* discussed the amount of debt being added in the latest round of corporate financial engineering. Merger and acquisition activity had hit an all-time record the previous year with about \$1.5 trillion of equities disappearing from the market due to buyouts. Mondays seemed to be a favorite day to announce deals. Merger Mondays led us to comment, "What do you know, another LBO?" LBO, of course, stands for leveraged buyout as substantial debt was generally used to finance the deals. We recalled how acquired firms often groaned under huge debt loads with several companies collapsing during the last wave of LBO activity in the 1980s.

Loading up companies with dubious debt didn't make much sense to us. The last LBO wave didn't end on a happy note, and we didn't believe this one would either. We acknowledged, however, that until the credit spigot was turned off, folks will likely keep asking, "What do you know, another LBO?" (Note: Our March 2007 warning proved accurate as it came before a colossal credit crisis crippled the global economy.)

**Don't Forget Rule #1** was the feature article of our **JUNE 2007** issue. As the stock market climbed to record levels, we found it helpful to review the reasons why the bull was charging, while remaining mindful of lurking liquidity, strategic and/or economic risks that might serve as this bull's menacing matador. Peter L. Bernstein, the author of one of the most comprehensive books about risk, *Against the Gods: The Remarkable Story of Risk*, discussed how risk is at the heart of all investment theories. He joked that the cockroach, one of the longest surviving species, has a great risk management system, "At the first sign of danger, they run like hell!" Warren Buffett, in his latest letter to shareholders, acknowledged risk management as a key criteria for his potential investing successor. "Over time, markets will do extraordinary, even bizarre things. We, therefore, need to find someone genetically programmed to recognize and avoid serious risk, including those never encountered before." More succinctly, Warren Buffett has said that there are two rules to successful investing:

**Rule #1: "Don't lose money."**

**Rule #2: "Don't forget Rule #1!"**

By investing in *HI*-quality firms at reasonable valuations, we sought to profit from long-term investing while minimizing risk—never forgetting Buffett's #1 rule.

After two issues discussing debt and other investment risks, the first cracks in our financial system began to appear due to debt and risky behavior as explained in our **SEPTEMBER 2007** issue, *Be Fearful When Others Are Greedy And Greedy When Others Are Fearful*. As housing prices bubbled up beyond any reasonable measure of affordability in many markets, those in the mortgage industry created innovative ways to lend money. Buyers with questionable

finances were issued subprime loans. Loosey-goosey lending policies resulted in no documentation loans (also known as liar loans), interest-only loans, negative amortization loans and piggyback loans (no money down). Most of these loans were bundled together and sold as mortgage-backed securities.

As long as housing prices continued to rise, everything was hunky dory for the borrowers, the lenders and the investors. However, as teaser and adjustable rates reset in flat or declining housing markets, defaults in the subprime mortgage market spiked. Borrowers were "shocked" by the higher payment they could not afford to pay, lenders were "shocked" by the higher defaults and investors were "shocked" that their investments were losing value.

As highly leveraged financial institutions were forced to dispose of securities to cover their debts and meet margin calls, buyers for subprime mortgages disappeared faster than ice cubes on a hot day.

Liquidity disappeared altogether for the more complex securities which became almost impossible to value due to the securities becoming swamped in FUD (fear, uncertainty and doubt). As fear overtook greed, a flight to quality ensued with investors seeking safety in U.S. Treasuries.

Meanwhile, fire-sale prices created buying opportunities for investors and *HI*-quality companies with ample liquidity. During this period, we followed Buffett's advice, "Be fearful when others are greedy and greedy when others are fearful."

**MARCH 2008** markets remained difficult. Our article, *Recession? Credit Crunch? Not For These Steady Eddies*, provided advice on the best investments for tough times. We acknowledged that, unfortunately, recessions and credit

crunches are a normal part of the business cycle. We believed that it would take time to unwind the excessive leverage in the financial system with further losses likely for those who didn't price risk appropriately. To help minimize risk, we suggested only investing in **HI**-quality companies with solid financial positions which enable them to not only survive but thrive during economic downturns.

While volatile markets created by recession concerns and credit crunches may be unnerving, investors realize that it is during these periods that great buying opportunities often arise. We advised long-term investors, shopping for bargains, that they should get ready to go steady with Eddie. A sample of our steady Eddies included: ADP, PepsiCo, Procter & Gamble, TJX and United Technologies.

**SEPTEMBER 2008** did not find any silver linings showing through the gray skies, but it did provide time for some rainy day shopping as recognized in our feature article, ***The Time Of Maximum Pessimism Is The Best Time To Buy***. The credit crisis that started a year earlier with subprime mortgages had now spread into all credit sectors and was contributing to a global economic slowdown. At the same time, rising energy and food costs heated up inflation. Throw in global tensions, rising unemployment and a presidential election, which could result in higher taxes, and it was no wonder that Mr. Market was extremely pessimistic.

However, we suggested that investors should keep in mind one of the quotes of the legendary global investor and great philanthropist, Sir John Templeton, who said, "Bull markets are born on pessimism, grow on skepticism, mature on optimism and die in euphoria. The time of maximum pessimism is the best time to buy and the time of maximum optimism is the best time to sell." With valuations for **HI**-quality

companies compelling, we observed that this may indeed be one of the best times to buy!

The next six months offered more challenges for investors to keep calm and stay the course. With the stock market down more than 50% following the financial crisis, the **MARCH 2009** issue reminded folks that ***The Future Has Not Been Cancelled!***

We were in the middle of the worst recession seen in decades. Every major asset category, including stocks, bonds, real estate and commodities had suffered significant losses resulting in the destruction of over \$30 trillion of paper wealth. The stock market was gripped by fear, panic and risk aversion. However, we predicted that this, too, shall pass. Like a stretched rubber band, we expected the stock prices of **HI**-quality companies would snap back strongly toward the intrinsic value of these excellent businesses once a fearful Mr. Market regained his confidence and composure.

We advised folks to keep in mind that long-term investors reap the highest rewards following bear markets. We had suffered through a number of bear markets during the past century and America's **HI**-quality companies always rebounded, and we fully expected them to do so again. As Fluor's management reminded us on their earnings conference call, "The future has not been cancelled!"

NOTE: As this newsletter was hitting mailboxes, the financial crisis bear market was reaching the bottom with the DOW at 6547 on 3/9/09. As predicted, the subsequent rally to a DOW near 18,000 has been extremely rewarding to investors who stayed the course.

The **SEPTEMBER 2009** issue brought warning bells in ***Cash For Clunkers***. The previous year a shocked world watched giant financial dominoes topple. In the Fall of 2009, after much angst and pain, the financial system and economy started to stabilize as the long road to recovery was paved by massive monetary and fiscal stimulus.

One of the most popular fiscal stimulus programs, "Cash for Clunkers," was rolled out to help jumpstart the ailing auto industry after GM and Chrysler filed for bankruptcy. Nearly 700,000 shiny fuel-efficient vehicles were sold to replace gas-guzzling clunkers.

In anticipation of the economic recovery, the stock market rallied strongly. The rally was led by the clunkers—those very financial stocks which contributed to the 2008 Big Crash. We warned that a caution light should flash when investors trade cash for clunkers, especially when the road to recovery was still filled with plenty of potholes. We further advised that investors riding in junky clunkers may soon see their investments stall out or, even worse, sputter and die by the side of the road.

Instead of trading cash for clunkers, we suggested that investors park their hard-earned dough in attractively valued **HI**-quality companies which offer a secure ride to long-term profits.

As we exited the winter season, **MARCH 2010** brought the kind of blizzard we like, ***A Blizzard Of Dividend Increases!*** The Blizzard of 2010 will not be soon forgotten for the folks in the Washington DC area. During the height of the storm, all activity came to a halt and weak structures suffered roof collapses under the weight of too much snow. After the record snowfall, it was difficult to gain traction as everyone tried to dig out of the mess. Even the Federal government had to remain closed for four days.

In a similar fashion, we believed that no one would soon forget the 2007-2009 financial meltdown that hit the global economy. At the height of the credit crescendo, economic activity came to a halt as business froze. Weak businesses collapsed under the weight of too much debt. Following the storm, the economy was attempting to gain traction. Many wished the government would close down once again instead of threatening higher taxes.

Despite the many challenges of the storms, **HI**-quality companies managed well through the turmoil. With strong cash flows and sturdy balance sheets, 14 of our **HI**-quality companies delivered a blizzard of dividend increases during the preceding three months with these dividends compounding strongly over the previous five years, too!

On average, the 14 **HI**-quality companies had increased their dividend each of the last 28 years based on confidence in their financial strength, long-term growth opportunities and their durable competitive advantages. The steadily growing dividends provided a powerful return to long-term investors. Even better, we expected these growing dividend income streams to bubble ahead of inflation in the years to come. With steadily growing dividends, we believed our **HI**-quality portfolio pantry to be well stocked to comfortably weather future blizzards!

In the feature article of our **DECEMBER 2010** issue, **All Aboard The QE2**, we noted that two years after the stormiest financial crisis since the Great Depression, the U.S. economy appeared to be finding its sea legs although unemployment remained unacceptably high and whiffs of deflation filled the air. As a result, the Federal Reserve announced plans to buy an additional \$600 billion of longer-term Treasury securities by mid-2011 in a renewed effort to spark economic activity through a second round of

quantitative easing—dubbed QE2. We wrote:

“Our **HI**-quality companies harnessed their ship-shape balance sheets, by raising more than \$20 billion of cheap capital during the past few months, thereby stockpiling cash for general corporate purposes, rainy day funds, acquisitions, dividends and share buybacks. While there will always be a few squalls when investing in stocks, our **HI**-quality companies, wearing life jackets filled with cash, should provide investors with smooth sailing over the long term.”

In **SEPTEMBER 2011**, we returned to the theme of keeping our eye on the value of our companies in our article, **When Mr. Market Hits The Panic Button, Focus On Fundamentals**. The stock market had suffered a substantial decline. Factors contributing to the stock market's drop included rancorous political bickering over raising the U.S. debt ceiling; S&P's downgrade of our nation's AAA credit rating; European sovereign debt worries; and fears of another global recession. Following S&P's U.S. credit downgrade, the Dow for the first time in 115 years experienced four straight daily 400-point swings with the market moving 4% on each of those days.

Amid this violent stock market volatility, it was no wonder a fearful Mr. Market hit the panic button. However, long-term investors know Mr. Market is subject to periodic panic attacks. We once again stressed rather than running for the exits, one is better rewarded by evaluating business fundamentals and the attractive valuations created by the panic. By focusing on fundamentals, successful long-term investors avoid the motion sickness of volatile markets and can take advantage of buying

opportunities created by other investors (and computers) dumping stocks without regard to the underlying value of **HI**-quality businesses

The Fall of 2012 found another major challenge facing the US economy. **SEPTEMBER 2012's** article, **Fiscal Cliff Ahead, Beep! Beep!**, detailed the issue. Regarding the national debt, potential tax increases and the “fiscal cliff,” we wrote: “Without Congressional action, Americans will face one of the largest tax increases in history and massive spending cuts beginning Jan. 1, 2013, which has been dutifully dubbed the fiscal cliff. With Congress acting like a bunch of Looney Tunes characters, the U.S. economy is threatened with falling off the fiscal cliff with a big SPLAT, much like Wile E. Coyote in a Roadrunner cartoon. Potentially diving off the fiscal cliff, however, is no laughing matter as another severe recession would undoubtedly ensue.

The mounting national debt is one of the biggest challenges facing the United States. While both comprehensive tax reform and significant spending cuts will be needed to close the growing deficit, we all know that Congress is as reluctant to cut pork from the budget as Porky Pig is to undergo liposuction. Yet not only will pork need to be pulled, but entitlement programs will also need to be placed on a diet.

Washington's inability to deal with the country's fiscal problems is taking a big toll on business and consumer confidence, hindering economic growth. Other concerns include healthcare reform, which has everyone asking, “What's Up, Doc?” Given all these challenges, many investors are selling their stocks and saying, “That's all folks!”

We believe giving up on stocks is a big mistake. We also expect the U.S. economy will behave more like the Roadrunner than Wile E. Coyote by making a sharp U-turn

before heading over the fiscal cliff. Before making rash changes to investment plans, long-term investors should remain focused on **HI**-quality business fundamentals. Happy endings can occur outside of cartoons!" (Note: As predicted, the fiscal cliff was averted.)

Tax issues continued to plague investment decisions when ***If You Let The Tax Tail Wag The Investment Dog, It Just Might Bite!***" barked onto the front of the **DECEMBER 2012** issue.

With the election over, the focus had turned to the looming fiscal cliff and the Bush tax cuts that were set to expire at the end of the year. Many folks, fearful of higher capital gains taxes, were not waiting for Congress to act and were selling stocks before year end, which we cautioned could be a big mistake.

Rather, we predicted that the likely tax compromise would result in the vast majority of Americans NOT facing a change in their tax rates, a forecast which proved to be correct. The lesson learned was that investors should be wary of becoming preoccupied with taxes at the expense of their long-term investment objectives. If you let the tax tail wag the investment dog, it just might bite!

With the stock market surging and valuations rising, the **MARCH 2013** issue again focused on selling. In ***Marching To A Different Drummer Than Mr. Market***, we attempted to answer the critical question of determining the right time to sell.

Relying on tried and true valuation principles, we once again advised that selling shares optimally occurs when a stock price approaches or moves ahead of the intrinsic value of the business. In illustrating our point, we revisited Mr. Market's "irrational exuberance" for dot-com companies discussed in our **MARCH 2000** issue and our advice at that time to reinvest in undervalued "old economy" stocks.

Thirteen years later, we found that those "old economy" stocks like

Clorox, Fastenal, General Dynamics, Genuine Parts, 3M, Procter & Gamble and T. Rowe Price were now fully valued and accordingly we trimmed back those positions, while technology stocks like Apple, Google and Microsoft now appeared very attractively valued and were purchased for the **HI** portfolio. We marveled at how times had changed. However, we observed that what had not changed was that rational investors focused on valuations will often march to a different drummer than emotional Mr. Market.

In the feature article from our **DECEMBER 2013** issue ***Dow 16,000, Now What?***, we again addressed valuations and our investment philosophy. The stock market was hitting all-time highs, which had us trimming back more stocks than usual as a generous Mr. Market was offering us full value for many of our **HI**-quality firms.

We remained patient and disciplined in reinvesting the sale proceeds as most companies we followed appeared fairly valued. In this rapidly rising market, bargain stocks are as scarce as hen's teeth.

With the Dow at 16,000, we reiterated that Hendershot Investments would continue to invest as we had always done—by focusing on individual companies and not the market.

As our loyal readers would expect, we again sang our familiar refrain: invest in **HI**-quality companies at reasonable valuations and hold them for the long term. However, when reasonable valuations are scarce, we will patiently hold cash until attractive values reappear.

**DECEMBER 2014:** After twenty tumultuous years, the Dow Jones Industrial Average is

hovering near 18,000, about an 8% compounded annual return since our first publication in 1994. The S&P 500 index, with dividends reinvested, has provided an approximate 10% annual return. Although we have not made the right call on every investment, we are very proud of our overall track record, which has significantly outperformed the indices over the same 20-year period.

As we embark on our next twenty years, Hendershot Investments expects to navigate through inevitable future stormy business cycles and other unknown challenges and risks by holding to the investment philosophy and principles that have served us so well for our first twenty years.

We remain committed to identifying and purchasing **HI**-quality stocks at reasonable valuations and holding them for the long term.

We will continue to seek to invest in companies with steady growth, strong free cash flows, solid balance sheets with little or no long-term debt, highly profitable operations and management teams that make intelligent capital allocation decisions. Those attributes have led to successful investment results over the past 20 years, and we believe they will continue to serve us well over the next 20 years.

### THANK YOU!!

We want you to know that we truly value the confidence and trust you have placed in us over the last 20 years. We sincerely appreciate that you chose Hendershot Investments to help serve your investment needs.

We look forward to many more years of working with you and pledge to do our very best to help you meet your investment goals. We are devoted to helping you conserve and grow your wealth. Thank You!!