7/30/2018

To the friends and clients of the Harvey Investment Company:

So far this year the stock market has been impervious to influences that most observers think determine its direction. Not tariffs, rising interest rates, furious political acrimony, or fractured international alliances can upend the stock price levels attained in the long bull market. In the second quarter, the S&P gained 3.43%, and July to date has been modestly positive.

This implacability might be the result of the continued flow of money into index funds and exchange traded funds (ETFs). Investors in such vehicles are not at all price sensitive. It's buy at any price, just get me in! So long as cash moving into this class of assets is positive, it is hard to imagine a declining stock market. For market bulls, it should be disconcerting to hear that the funds' popularity may be waning and that demand for them may be satiated.

BlackRock and Vanguard Group are the largest of the sponsors of the passive investment funds. Each notes a significant decline this year in investor commitments in this area. BlackRock says that it had $20 billion in net inflows to its funds in the second quarter, an enormous sum to be sure. But it is far less than the $100 billion it took in during the second quarter last year. The slowdown is most pronounced on the ETF side, where the industry reports a 50% decline in inflows through the first six months of 2018. Still, the inflow was huge----$128 billion. Nevertheless, the current trend bears watching as a flip to net outflows could spell trouble for the equity markets. There is no reason to believe that sellers who don't care what price they receive when they sell won't have just as great an effect on the downside as the passive, index fund buyers had on the upside.

In our original quarterly letter eighteen years ago, we stated that our main purpose was to implement for our clients "an investment discipline, which, if practiced diligently, leaves wide open the opportunities for the tremendous benefits common stocks offer and, also, meaningfully reduces the risk of substantial, permanent loss of capital." We have practiced this discipline every year since and continue to do so. The technique employs an elaborate set of rules that define it. Its application produces a well-defined group of investment choices. Though until this year we had not formally codified our processes, we have always known exactly what we were looking for. The rules were simply internalized in our thinking. As our business has grown much larger, and the decision making team has expanded, we decided it was important to detail in writing the important tenets that lead to our actions.

One of our insights from this project was that whatever success we have had stems not so much from what we do, as from what we will not do. For example, our criteria for stock selection include seeking: 1) Companies that have been reliably profitable for at least 7 to 10 years, 2) Companies that have produced net income as a percentage of total assets of 7% or greater for at least the past seven years. These criteria alone eliminate a large swath of stocks from consideration and, more importantly, we are left focused exclusively on companies that likely possess important business advantages.

We also set forth eight crucial features we like to see in management teams. Here are two examples: 1) we look for Chief Executives that have a deep understanding of the details of the business including a complete understanding of its financial statements and accounting, and 2) managements that have engaged an astute Board of Directors that is anxious to govern a winning team. The deeper we get into analyzing a company the more intuition and past experiences are brought to bear, particularly as it relates to judging management.

The codifying also crystallized something we already knew. Our analytical technique consists of a long series of no's leading up to a final yes. It's **no**, the CEO pays himself too much; **no**, the company's advantage is wearing thin; **no**, the sales force is experiencing too much turnover. And the **no's** go on until we uncover an opportunity that has no **no's.** Oddly, this insight brought to mind the old, perhaps apocryphal, quote attributed to Michelangelo, "I saw the angel in the marble and carved until I set him free."

We expect the codification of our investment techniques to strengthen our product and your performance in two important ways. First, it will make the search for potential investments and seeing the work on them through to completion more accessible for our research team. Secondly, codification provides a strong framework with which to analyze our mistakes. We can point to specific areas where we strayed or didn't give enough attention. In this business, nothing is more important than facing up to mistakes and learning from them.

Charlie Munger once said, "There are no new eras, only new errors." Hopefully, codification and the many lessons learned from past missteps will keep both new and old errors to a minimum.

We are most appreciative of your loyalty and belief in us. It makes the work worthwhile and the days lively and interesting.

Sincerely,

Samuel C. Harvey