Warnke/Nichols Ltd.
INVESTMENT MANAGEMENT

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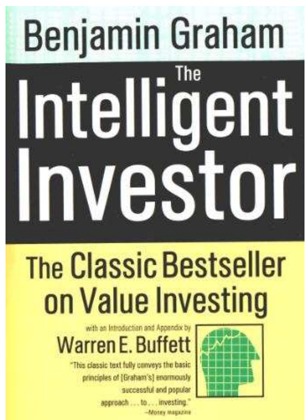
LETTER OF VALUE

Ruminations for investors seeking to enhance their wealth using the principles of VALUE INVESTING

Special 25th Business Anniversary Issue!

We opened our doors as "Merit Investment Group" on June 23, 1993, so we're excited to mark 25 years as an independent money manager. The breakout was motivated by the desire to help investors – who might not have the time, interest, education, experience, or temperament – protect and build their wealth OUR WAY, via a disciplined, patient investment approach, unencumbered by the big institutional bureaucracy, employee turnover, high fees, herd mentality, investment committees, pooled investment funds, and lack of flexibility.



Warnke/Nichols Ltd. has grown its managed assets to over $140 million among 86 client family relationships, from just a little more than zero in a few family accounts in the beginning. We can't thank you enough for your trust and confidence. We'd be nothing without you, who we consider our business partners.

We've Come A Long Way!

The popular Standard & Poor's (S&P) 500 Stock Index closed at 443.19 on our opening day, June 23, 1993. As this is written, 25 years later, the S&P 500 closed at 2767.32 – a total gain of 524%, or an average annualized rate of 9.6% including dividends.

Apples-to-apples, before fees and expenses, our small group of hand-picked stocks has grown over 1,282%, or an annualized rate of 11.1% including dividends over the past 25 years. With many bumps in the long road, including sleep-depriving downturns in 1998-9 and 2007-8, it's a market-beating record of compounding wealth to be very proud of.

We'll revisit performance history further in another section below. Meantime, we thought you might like a recap of the basics – philosophy, process, performance, and people – that underlie our day-to-day investment activities.

- **Philosophy**

VALUE INVESTING is the process of buying any asset at a price substantially below its estimated worth, to achieve the highest return on investment, consistent with preservation of capital.

Value investing has produced exceptional results in the stock market since the early 1920s. The approach is based on proven principles pioneered by Benjamin Graham and advanced by seasoned investors, most notably Warren Buffett of Berkshire Hathaway Inc. Buffett, arguably the world's most successful stock market investor over the past 60 years, was Graham's most gifted student and a business partner.

Graham's Intelligent Investor, first written in 1949, is perhaps the most influential financial book ever written. Its value investment philosophy and techniques are arguably as relevant today as they were when he first started working in Wall Street nearly 100 years ago. His teachings have withstood the test of time across a wide variety of market conditions, countries, and asset classes.

> ***An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative.***
> Benjamin Graham

- **Process**

We choose appropriate investments in client accounts based on a rigorous analysis of company financial and stock price data. Stocks are nothing other than ownership interests in businesses. We buy minority stakes in companies with the intention of holding them for a long time, while the prices of the stocks move up in tandem with the underlying value of the businesses.

Dozens of academic studies over the past 80 years, plus our own 40+ years of experience each, confirm that certain business financial characteristics are associated with exceptional long-term results and low risk in the stock market.

Investing with a margin of safety.™

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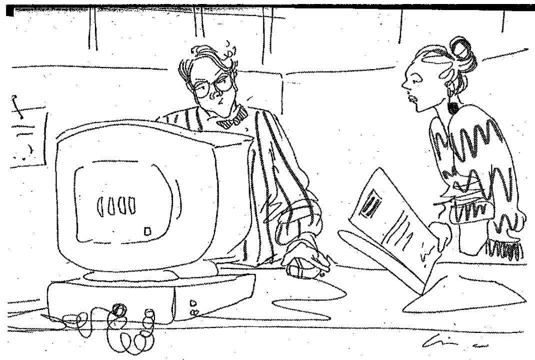
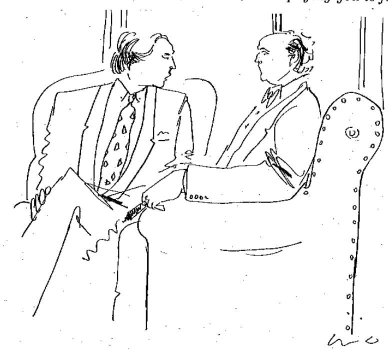


"We're not paying you to look for stocks, we're paying you to find stocks."

"It's agreed then, Halvorsan. I won't call you a 'bean counter' if you don't call me a 'numbers cruncher'."



"I buy what no one wants and I sell what everyone wants."

"I'm scouring all over for stocks. You can find good fruit on the ground as well as on the tree."

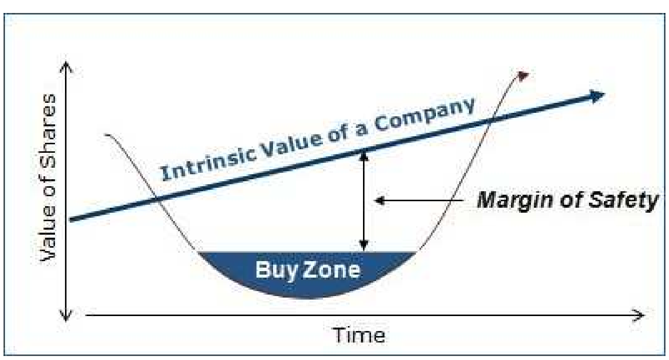
Through the research and business appraisal process, individually managed portfolios hold stocks of 12-20 U.S. companies that possess one or more of the following traits:

- <u>Deeply undervalued</u> stocks selling at low prices in relation to their companies' earnings, assets, cash flow, dividends, and estimated worth
- <u>Highly profitable</u>, earning consistently high returns on sales, equity, and invested capital
- <u>Financially strong</u>, with ample liquidity, high levels of excess cash, and low debt
- <u>Owner-managed</u>, with significant ownership of the company's stock by officers and/or directors
- <u>Small-to-medium sized</u> seasoned companies
- <u>Significant decline</u> in stock price prior to purchase.

How do you find the stocks to buy? We'll look at investment candidates from anywhere. Ideas come from numerous sources: a nine-thousand-company database we filter for companies that meet our financial soundness, profitability, growth, ownership, price, and value tests; financial publications (we read a lot); shareholder letters written by mutual fund managers we respect; and we've gotten a few good ideas from clients and peers.

We also have a mental database, accumulated over 40+ years in the investment business, of favorite industries and companies. Importantly, the companies must be in businesses we understand – within our "circle of competence," as Buffett would say.

Then what? For each of the 70-80 companies that meet our tests, we calculate what we think each will be worth today (called "present value"), based on an analysis of the companies' future sales, profitability, earnings, and cash flows. It's a business appraisal process a potential private buyer might use if he or she was buying a whole company.



Finally, we compare the estimated, or "intrinsic," value of each company to the current quoted stock price. If the stock is priced at a large discount to value – say, one-third to one-half off – we'll look to buy it. If not, we'll pass and wait for a lower price. You earn good returns on investment, with a large margin of safety, if you're consistently able to buy a dollar's worth of a company for considerably less than a dollar.

How do you build a stock portfolio? A well-diversified portfolio holds 12-20 stocks among several different industries. We generally hold stocks for a LONG time, as our average holding period is over 6 years. If the company continues to grow its value and its price-to-value ratio is not outrageously high, we'll continue to own it.

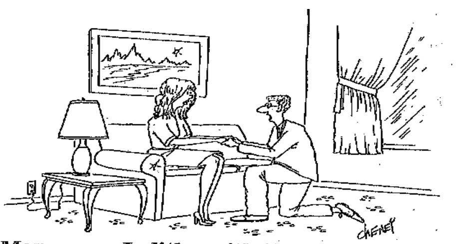
Do you ever sell? Of course! There are four reasons we'd sell a stock: (1) if it becomes too large a position in an account, we'll cut it back; (2) if the stock price rises to 90% or more of underlying value, we'll consider sale; (3) if we hold our maximum of 20 stocks and a new idea comes along, we'll eliminate another stock to make room; (4) perhaps we made a mistake in analysis or judgment and our original investment thesis is no longer valid; we'll sell the stock, take our lumps, and move on.

Bottom line, we're intensely focused on the process. The outcome – satisfactory investment returns – will follow if we work the process continuously and consistently.

- **Performance**

Value investing is a risk-averse approach. The priority is to preserve invested capital and minimize the risk of permanent losses. If we accomplish this, the investment returns fall into place. Performance has three elements:

- You PRESERVE your invested capital by owning stocks of a diversified group of financially sound companies bought at bargain prices. The favorable difference between a stock's quoted price and its estimated worth is called the MARGIN OF SAFETY. The safety margin minimizes the possibility of suffering permanent losses due to analytical error, miscalculations, or bad luck
- You GROW your invested capital by owning a small group of profitable, growing companies at prices considerably below the estimated worth of their underlying businesses. Over time, your wealth increases as stock prices move up toward their companies' rising business values
- You GROW your invested capital by minimizing portfolio expenses – long-term ownership of stocks, the creation of long-term capital gains, infrequent buying and selling, and minimizing brokerage commissions.



"Marry me, Judith...with the understanding, of course, that past performance is not a guarantee of future results."

- **People**

We re-incorporated as Warnke/Nichols Ltd. in June 1998. Twenty years later, it's still just the two of us – no other owners, no staff – and we like it just fine that way.

Bill (68) began his investment career in 1972, armed with an MBA from Wisconsin-Madison and BBA in Finance from UW-Whitewater. It didn't take long for him to gain valuable experience in a "down" market, as stocks crashed from the go-go highs in one of the worst downturns in history toward the final lows in 1974 while managing investments at an Illinois-based insurance company.

Prior to partnering with Steve to form Merit Investment Group, Bill spent 17 years as an analyst and portfolio manager at two large Milwaukee bank trust companies.

"Cheer up, Steve . To a value investor, unpopularity is a __good__ thing."

Steve (61) earned a BBA in Finance, also at UW-Whitewater, before stints at two bank trust companies and a large life insurance company in Milwaukee, as a security analyst and portfolio manager. His first big test as a money manager didn't come until the Crash of 1987 in which, as clear in mind as yesterday, the DJIA dropped 22% on October 19.

Both of us have earned the Chartered Financial Analyst (CFA) designations, Bill in 1979, Steve in 1982.

Today, we share the portfolio management, analytical, and client service responsibilities, considering ourselves interchangeable. In addition, Bill mostly oversees operations and finances, while Steve takes on compliance. We moved our office to downtown Delafield in western Waukesha County in late 2016, after 20 years in Hales Corners in suburban Milwaukee.

Bill is a long-time resident of Mukwonago, with a family of four grown children – a son and three daughters – and seven grandchildren, all living close by. Steve is a new resident on the outskirts of Oconomowoc, with two grown daughters who live out of state.

More on Stock Returns

Tweedy, Browne Company LLC is an old-line investment manager for the Tweedy, Browne mutual funds and private accounts. The firm's annual investment advisor's letter to fund holders had an interesting study.

The firm looked back over the last eighteen years to find that there were two starkly different stock market environments. Between 2000 and 2009 US stocks as a group declined. Contrast that with the 2009 to 2018 period, in which stocks have had one of the best bull market runs in history.

Here are the numbers, with our performance* depicted alongside the market:

- **March 31, 2000 to March 31, 2009** total returns:

	S&P 500	Warnke/ Nichols (stocks only)
o Cumulative	-38%	+61%
o Average annual	-5.1%	+5.4%

- **March 31, 2009 to March 31, 2018** total returns:

	S&P 500	Warnke/ Nichols (stocks only)
o Cumulative	+300%	+286
o Average annual	+16.7%	+16.2%

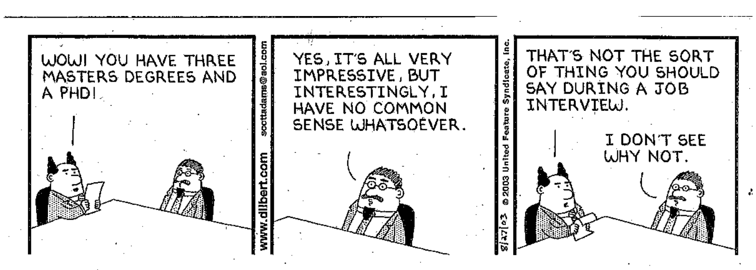
- **18 Years ended March 31, 2018** total returns:

	S&P 500	Warnke/ Nichols (stocks only)
o Cumulative	+150%	+521
o Average annual	+5.2%	+10.7%

By sticking to a value investing philosophy through thick and thin, we managed to achieve positive returns while the stock market tanked in the early 2000s. We resisted the euphoria and insane valuations of the telecom and tech sectors, which suffered a devastating crash beginning in early March 2000. Furthermore, in the 2007-9 crash during the financial crisis at the end of the nine-year period shown, the value approach struggled, but held up better than most.

From insanely low valuations associated with investor despair in 2009, we stuck to our value style and fully participated in the nine-year bull market that followed.

Putting the entire eighteen-year string together, the patient value investing philosophy performed quite well, with several bumps along the way. While past performance doesn't guarantee future results, the odds of producing pleasing returns going forward are high if we continue to work the disciplined process described in detail above and BUY VALUE.



The Arithmetic of Value Investing

Thankfully, because no one would accuse us of having high IQs, it doesn't take a high level of intelligence or a PhD in algebra to evaluate investment candidates. The most desirable qualities are discipline, common sense, patience, and a narrow emotional range.

If you pay 60 cents for an asset you believe is worth a dollar, your upside is about 67%. You MUST have the patience to wait, though, for the marketplace to bid the stock price up toward your well-reasoned appraisal of its underlying value.

> ***The most important quality for an investor is temperament, not intellect. You need a temperament that neither derives great pleasure from being with the crowd or against the crowd.***
> Warren Buffett, Chairman, Berkshire Hathaway Inc.

If the price-value gap narrows over three years, your annualized return is 18%. If the price-value gap narrows over five years, your average annual return is more than 10%. If the stock price goes nowhere, chances are the margin of safety between price and value was large enough to keep you from taking a permanent loss.

There are two added kickers that could make your investment even better. First, the company could continue to grow, so the stock price could rise further toward an upward moving valuation. Second, most companies pay cash dividends, which aren't even factored into the calculation of intrinsic value. These occurrences enhance your "total return" on investment.

> ***… we feel obligated to repeat a message from earlier (shareholder) letters. 'Markets will fluctuate and will decline, but you have entrusted your capital to managers making informed rational business decisions based on proven principles. When declines occur we will all suffer, but the soundness of our philosophy and the quality of our businesses and their management should provide us comfort and continued long-term success.'***
> David Carr & George Brumley, Co-Managers, Oak Value Fund

Thanks

Once again, we appreciate your trust and confidence. It's been a nice run, and we'll continue to stick to what's worked well over the last 25 years as a business, and more than 40 years as professional investors. We're not done yet!

Steve Nichols, CFA **Bill Warnke, CFA**

**For more information, including complete performance history, fee schedule, and SEC Form ADV, Part 2 (brochure), contact us at*

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