

**ADV Firm Brochure
Available Online or By
Request**

Inside This Edition:

- **The Good, The Bad, The Dusty**
- **Corporate Taxes**
- **Household Summary**
- **Individual Account Reports**
- **Material Changes To Firm Brochure**

Important Reminders:

- **April 17—IRA Deadline**
- NYSE Closed - No Checks, Deposits or Settlement on:**
- **May 28—Memorial Day**
- **July 3—Early Close**
- **July 4—Independence Day**

C CAIRN INVESTMENT GROUP

121 SW Morrison Street
Suite 1060
Portland, Oregon 97204
Phone: 503.241.4901
Fax: 503.241.5699
E-mail: info@cairninvestment.com

Greetings from the Northwest.

How many of you have taken a trip to one of the fabled movie lots in California or elsewhere across the country? Movie lots where fabulous, action-packed scenes have kept us all at the edge of our seats. Well, that's where I feel we've been. I can see and feel, almost taste, the dust in the clapboard buildings. The peeling paint, a couple of window panes broken out. Maybe a curtain flapping in the breeze through the broken window. I can smell dust, maybe I can smell the livery stable, maybe I can smell a little coal smoke, maybe someone cooking. And here we are on a quiet Easter weekend and April Fools' Day, when out of the East, with the sun to his back, comes a wild cowboy with pistols in both hands. The bullets begin flying and I start dancing, I jump up to avoid a bullet hitting my ankle, I dodge to the left, I dodge to the right, I keep on dancing as the bullets fly around me. Breaking another window, splintering some other wood boards, and of course punching a couple of holes in that classic water trough near the livery. This is what the last few months have felt like, unplanned, and very unsettling. It may be that disruption is the way to get people focused on the issues that our country needs to address. But, my gosh, it is difficult for the markets and investors to have a sense of stability with all of the disruptive, High Noon activity.

Over the years many of you have heard me say that I don't worry too much about the markets overall. What I care about are the individual companies that we own. Companies where folks are making decisions daily on how to make their business more profitable, more appropriate, and more relevant. These are the things that I'm focused on, and it may be that the business environment is changing in a positive way. Earnings, dividends, backlog of work not yet done, promising future new technologies: These are important to me as we wrap our thoughts around what we as investors should own.

In the past I've talked about our wall of worry. I'm not going to do that. From time to time I've talked about



Tanque Verde Ridge Trail, Saguaro National Park Photo by: Ted H.

interest rates. I'm not going to do that either. But I do think there is a change in the way businesses are being managed from a tax perspective, and how we need to think about taxes and the way we own our investments. How we as investors are going to act

and how it may have an effect on our returns. Patrick is going to take an important part of the message today and reflect upon the changes that we see in the way companies are aligning with new tax rules and with increasing interest rates.

I would encourage you to call up and schedule a time to come and see us. If you haven't had a chance to talk with Patrick and/or Tim lately, it's a great thing to do. Any of us are happy to sit down and review your world and your investments. Patrick has been with us nearly three years and has a wonderful handle on so many of the companies we invest in.

One of the tragedies that we bumped into recently is that Theresa, who was absolutely delightful to have on our staff, has become one more casualty of the very difficult daily commute from Southwest Washington into the Portland Metro area and back. That being said, we are very excited about introducing you to Kim Weatherman. Kim is well experienced, a veteran from banking, insurance and investment firms. She most recently was with Columbia State Bank headquartered in Tacoma, but working here in one of the local Portland branches in its small investment arm. Please join me in welcoming Kim and don't hesitate to give her a shout and say hello. It is comical that we now have a Jim, a Tim, and a Kim. We just try to say it clearly for each other.

Many of you have heard me talk with enthusiasm when it comes to my belief that the economy will continue to march along, sometimes at a bustling rate and sometimes slower. Currently we are at a fairly brisk rate, and that's a "good thing" for investors. So, as I often do, while driving down the road and see other people in their cars, or if I'm in the office and look out and see other office windows or other business doors, I remember that behind every single one of those cars, businesses, or offices is somebody just like you and me, trying to figure out how to put some more money in their wallets for all of the things that they would like to do in their lives. It's a very compelling economic growth story. As we see businesses hiring more, we are enthusiastic about an ongoing improving and growing economy. That being said, we all know that if there is one thing that causes jittery markets, it is uncertainty, and right now we have a lot of uncertainty.

Patrick's Part

So much for the low volatility that investors have become accustomed to over the previous couple of years. The first quarter saw markets rise to an all-time high by the end of January, only to finish the quarter in negative territory. The S&P 500 Index finished down 0.76% for the quarter while developed international stocks fared a bit worse, -2.2%. Emerging market

equities fared the best of the major asset classes, returning over 2.4%. Bonds were also mixed as yields were quite volatile, reflecting consistent economic growth while the U.S. Fed continues on its interest rate hike path. As we have written previously, we view broad U.S. stock indices as richly valued and that view has not changed during the quarter. Finding bargains in this environment is challenging but we remain vigilant in our search for quality investments selling at compelling prices, while decreasing our exposure to companies that have become more fully valued. As Jim mentioned, I am going to discuss some of the changes that companies will be facing regarding tax rates and the rising costs of borrowing.

Last quarter we briefly touched on the changes in tax law that focused on individuals. There was also a broad overhaul to the corporate tax structure that many companies are still trying to dissect three months after the fact. The two primary changes that are being talked about the most are the lowering of corporate tax rates from a high of 35% down to a flat rate of 21%, and the changes to the deductibility of interest expense on corporate debt. The latter change is not talked about as frequently, but could be of more importance in the years to come.

We spent a lot of time in early 2017 identifying companies that could benefit the most from a lower corporate tax rate. That benefited portfolios later in the year, as companies with high effective tax rates were strong performers in the back half of 2017. Companies that benefited the most had similar qualities: low debt and a large proportion of U.S. revenues. The use of funds that companies are netting, resulting from lower tax, is still not completely clear, so it will be interesting to hear executives speak about their plans during upcoming earnings announcements. While an increase in productive spending (research, capital equipment, employee training and technology enhancements) would be welcome news, we remain skeptical, as historically tax savings have been used to increase executive compensation and share buybacks. Also, the increased chatter of trade tariffs/wars and possible effects on corporate profits could weigh on the benefits that were perceived from lower corporate tax rates.

A very important part of the tax law change surrounds the deductibility of interest expenses for corporations. Historically, the interest expense on the debt issued by companies was fully tax deductible. Over the last 10 years, this allowed these firms to access the bond market at historically low interest rates and have the interest expense be tax deductible (what a deal!). Under the new tax law only part of the interest expense is tax deductible (up to 30% of operating earnings before depreciation). Companies that have large amounts of debt or increasing interest expenses are now more susceptible to lower profits. We feel this is a risk that is currently underappreciated by equity markets. As the chart below shows, corporate America has taken on large amounts of debt



CAIRN INVESTMENT GROUP

over this past cycle, rising from roughly \$3.6 trillion to over \$6 trillion. This is at a time when the costs of corporate debt have started to rise (indicated by the red line, 3 month LIBOR). See chart below.

As interest rates have begun rising in the corporate market, this creates a headwind surrounding balance sheet strength, financial flexibility, and corporate profitability going forward. While we continue to look for attractive investments, these potential headwinds will be considered. We always strive to invest in companies we feel are financially healthy. Financial health and cash flow strength could separate the winners from the losers as we reach the later innings of the market cycle. Where we cannot find these suitable investments, we are comfortable being patient to protect against downside risks. – *Patrick Mason*

We will get past this tariff noise. We're going to continue to keep our eyes open and try to dance around those surprising puffs of dry dust that are poofing up near our feet. Please remember that any time you are in town we'd love to see you. Don't hesitate to come on in. The coffee pot is always on.

Happy Trails,

Jim Parr, Principal
Cairn Investment Group, Inc.

