Second Quarter Letter 2017

PERSPECTIVE

There is a strongly held perception that Wall Street's analysts tend to call a stock a "strong buy" when its price and earnings are high and to label it a "sell" after its price and earnings have fallen. Many investors also tend to follow the momentum of the market, wanting to invest when the market is rising and sell when the market is falling. Such investors and even some sophisticated stock analysts confuse the high earnings during favorable economic times with the average earnings power of the company. Investments purchased at peak earnings or at high multiples often do not offer an adequate margin of safety or long-term rate of return.

Value investing is conceptually easy to grasp but a difficult discipline to practice as it runs contrary to a herd mentality.

Margin of safety is a fundamental principle of value investing, which states that an investor will purchase a stock if it is priced below its intrinsic value. Intrinsic value is the economic value of a company based on its long-term earnings power. The difference between the purchase price and the intrinsic value is the margin of safety. The greater the difference, the larger the margin of safety that provides an extra cushion in the event of future pressure on earnings from a myriad of factors (economic, market or company specific). Prices fluctuate more than intrinsic value, meaning opportunities exist to take advantage of irrational pricing and market psychology.

The purpose of margin of safety is not just to preserve the initial capital investment, but to improve upon it. When a stock is purchased below its fair or intrinsic value, the expectation is that in some future time period the stock price will converge with its fair value in a rational market. If the growth expectations end up being correct, an investor who has bought at the discounted price will ultimately earn a superior rate of return.

Our First Quarter Letter noted that the current bull market celebrated its eighth anniversary on March 9, 2017. Value investing and margin of safety concepts are not so attractive in rising markets. The essence of value investing is finding a veritable bargain, which can be difficult in an aged bull market. As we've mentioned before, value investing is conceptually easy to grasp but difficult to practice as it runs contrary to a herd mentality. It entails researching investment options in depth, usually to discover the stock is fairly priced even though it shows some value attributes. It requires patience and a willingness not to participate in market momentum or a particular sector fad. It also requires fortitude to invest "in the foulest of weather." Purchasing stocks in a declining market without knowing the bottom can be challenging. Stocks tend to trade at their greatest margin of safety during negative economic periods when investors are overly pessimistic.

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Value investing also involves having a certain part of your portfolio in cash, ready to deploy when an opportunity arises. Surplus cash increases during a rising market as prices reach intrinsic or fair value and gains are realized – that translates into watching the stock market reach new highs with a percentage of assets in cash. This is why value investing is regarded as a difficult discipline in practice. There has to be a certain detachment about what the market is doing, while focusing on individual stock valuation and the fundamentals of the investment.

Delta follows a value investing approach and initiates new positions in its model equity portfolio utilizing a reasonable margin of safety. Although the attributes of value investing and utilizing margin of safety are not readily apparent in a rising market, they are inestimable in a declining market. Purchasing new positions in the model portfolio at a discount to intrinsic value and holding cash helps lower the volatility and provides liquidity to initiate new positions at lower prices.

As of this writing, there are a number of conventional indicators that suggest stocks are expensive. Despite these signals, the market could continue to rise and forge new highs. We feel the best way to deal with future market turbulence is by hewing to an investment discipline that doesn't focus on short-term market performance. We favor taking a long-term view and applying discipline, patience and judgment as the best means to increasing value and managing the volatility and uncertainty that is always present, whether visible or lying just beneath the surface.

Dated: June 26, 2017

COMPANY COMMENTS

Comments follow regarding common stocks of interest to clients with stock portfolios managed by Delta Asset Management. This commentary is not a recommendation to purchase or sell but a summary of Delta's review during the quarter.

The Walt Disney Company {DIS}

The Walt Disney Company is a global, diversified entertainment company with operations spanning theme parks, broadcast and cable television, movie production and consumer products. The company owns some of the world's most valuable media brands including Disney, ESPN, ABC, Pixar, Marvel and Lucasfilm (Star Wars). Disney's broad media and entertainment scope provides diversified distribution channels for the company's creative content. Over the last several years, Disney has focused on three key strategic priorities: creating high-quality content for the entire family; making that content more engaging and accessible through the use of technology; and growing its brands and businesses in markets around the world. The management team, headed by Robert Iger, has proven adept at creating value by generating multiple revenue and profit streams from its brands.

Disney's core strategy is to exploit characters and storylines by spinning them into multiple and enduring products. In addition to revered legacy brands, such as Mickey Mouse and Disney

Princesses, the company has many new flourishing franchises ranging from *Frozen* and Marvel characters, such as *The Avengers,* to the resumption of the Star Wars epic. Disney showcases these brands through multiple platforms of the company, from films to theme park rides to DVDs and video games to toys and other consumer products. Disney estimates that it owns five of the top six character franchises based on merchandise and consumer sales.

Disney theme parks are one-of-a-kind destinations. Although there is competition, none have the scale, magnitude, uniqueness or relevance that the Disney theme park experience provides.

Disney's competitive position is strongest in its theme parks and media offerings (cable channels), which generate the majority of the company's profitability. Disney's majority-owned ESPN networks are the dominant sports broadcasters in the U.S. Benefitting from the dual revenue stream of cable company surcharges and advertising, ESPN has grown to also include ESPN2, ESPN News, ESPN Classic, ESPN Deportes, the largest radio network in America, a website that clocks over 50 million visitors a month and a $100 million ESPN theme park in Florida.

Sports are Disney's major content edge. As consumer viewing options grow (internet and mobile media) and become more fragmented and viewing preferences change, "must see" live sports provide ESPN with an advantage over its traditional cable distributors and advertisers. ESPN profits from the highest affiliate fees per subscriber of any cable channel and generates revenue from advertisers interested in reaching adult males ages 18-49, a key advertising demographic that watches more sports and less scripted television than other groups. These recurring, high margin cable affiliate fees provide profit stability in most economic backdrops.

Disney's theme parks and cruise lines contribute approximately 20% of operating income. In addition to the wholly-owned domestic parks -- Disneyland and Disney World – the company has partial ownership and management contracts to operate several international parks, including France, Hong Kong and Tokyo. Disney has invested heavily the past few years, adding new attractions, new resorts and new cruise ships as well as park expansions and upgrades. In early 2016, Shanghai Disney opened and could be a big boost to theme park growth. The park gives Disney a great opportunity to penetrate the Chinese market, capitalize on its huge population size and help drive consumer products growth in the country. It is estimated that 330 million people live within a three hour train ride of the park. Disney theme parks are one-of-a-kind destinations. Although there is competition, none has the scale, magnitude, uniqueness or relevance that the Disney theme park experience provides.

Disney does face long-term challenges. The cost of sports programming rights continues to rise sharply, and ESPN pays handsomely to acquire major sports contracts. ESPN has been able to defray some of these costs by charging ever-increasing affiliate fees to cable operators. With such high fees, angst is growing among viewers, cable operators and program competitors. If ESPN cannot continue to pass along sports rights costs to cable operators, its profit margins will erode; however, profit erosion would be gradual due to ESPN's long-term contracts with both major sports leagues and cable operators. The high value of sports has also created additional competition for ESPN. All major broadcasters, such as FOX and NBC, and the major sports leagues themselves have increased their investments in sports programming. More competition for viewers is likely to drive up the overall operating costs to broadcast sporting events.

Disney's proven ability to develop entertainment icons with increased consumer opportunities from merchandising royalties, positive cable pricing and theme park expansion internationally should allow the company to continue its good revenue growth with solid operating profit margins. Our valuation model suggests that the company's stock is priced to generate a long-term average annual rate of return of approximately 7%.

Wells Fargo & Company {WFC}

Wells Fargo is one of the largest diversified financial services firms in the U.S., with a nationwide network of several thousand branches and more than 15,000 financial advisors. The bank offers a full range of consumer, commercial and investment banking services. Based in San Francisco, it is the top deposit gatherer in the U.S. The Wells Fargo model delivers a vast product set through a scaled domestic office / technology infrastructure with disciplined risk management.

Wells Fargo is largely a conventional lender. The bank's $1 trillion plus deposit base and near dominant market position in fast growing markets are its biggest advantages. The bank funded its balance sheet at 40% lower cost than its North American peers. It is able to generate 30% more revenue per dollar of assets than its peer group. The company also has a leading position in the mortgage market. The firm benefits from economies of scale in both origination and servicing. An additional strength is the diversification of revenue. Wells revenue remains diversified, relying on the more stable revenue generated by its brokerage, advisory and asset management businesses. Trading gains made up only 1% of non-interest income.

The company's challenges in 2016 were among the toughest in its history. Unacceptable practices in the retail bank resulted in accounts being opened for customers of which they were unaware and neither needed nor wanted. The company has taken a number of steps to restore customer trust. The company has eliminated product sales goals and implemented a new retail banking compensation program in 2017. The new program weights incentives toward team goals, customer satisfaction and product usage. Additional monitoring and controls were put in place to provide enhanced oversight of sales processes. The company now sends out confirmation emails an hour after opening new accounts to ensure customers are only getting what they requested.

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The Wells Fargo acquisition of Wachovia during the financial crisis in 2008 doubled its branch count and gave it exposure to the eastern half of the country. A Wells branch or ATM is now within two miles of half of America's homes and half of its firms. The Wachovia acquisition also gave Wells the third largest network of stockbrokers in America, trailing only Merrill Lynch and Morgan Stanley.

Wells boasts strong market share positions in many of the largest, fastest-growing and wealthiest markets in the country, which should help the bank grow organically faster than the banking industry on average. In addition, Wells Fargo's balance sheet strength has allowed it to gain market share from banks needing to reduce assets and raise liquidity.

Wells is likely to experience continued net interest margin pressure in the short-run, due largely to low interest rates, bank competition and increased liquidity requirements. Over time, we believe net interest margin will expand as interest rates rise and the lending environment stabilizes. Another challenge is the possibility of higher funding costs going forward. With the Trump election, there is the potential for less regulation of the banking system, reducing regulatory compliance costs as well as easing future bank capital rules.

We anticipate the company's efficiency ratio will improve over the intermediate term as the company benefits from a declining regulatory burden, rising interest rates, a somewhat smaller branch network and annual non-interest income growth. We have assumed Wells will continue to maintain excess capital and liquidity above the required norm. Based on our assumptions, our financial model indicates that at the present stock price, Wells Fargo's stock offers a potential long-term annual return of approximately 7%.

Honeywell {HON}

Honeywell, one the world's largest industrial and manufacturing conglomerates, is organized into four diverse segments: Aerospace; Home and Building Technologies; Performance Materials; and Safety and Productivity Solutions. The broad range of products enables the company to offset risk in any market or region with strength in another. In recent years, the company has benefited from strength in the global aerospace market, offsetting domestic U.S. market weakness and inflationary pressure with pricing and productivity gains.

Honeywell is one of only a handful of companies that have deep experience and scale in mass producing high output turbochargers. It is estimated that tighter emission regulations and eventual higher gasoline prices will drive double digit growth for turbochargers in the years to come.

Much of the positive shift in Honeywell's fortunes can be attributed to its recently retired CEO. David Cote arrived in 2002 while the company was struggling with two conflicting cultures as a result of the merger with Allied Signal. The company also was dealing with a highly cyclical and commoditized product portfolio. As the new CEO, Cote quickly meshed the cultures and shifted Honeywell's portfolio toward technologically sophisticated offerings with bigger competitive moats and higher margins. The company focused on core growth themes of energy conservation, power generation and industrial safety. In the subsequent decade, Cote diligently transformed Honeywell, making 70 acquisitions and jettisoning 40 slower growth, cyclical businesses. In April 2017, company veteran Darius Adamczyk succeeded Cote, following Cote's 15-year tenure as CEO. Cote remains as Chairman.

Honeywell allocates a high percentage of cash resources to research and development (R&D) spending. R&D spending is over 5.0% of revenues (roughly twice the industry peer average) and targeted at high growth areas to enhance product attributes and differentiation. Turbochargers represent one of Honeywell's technologically sophisticated growth offerings. Currently, approximately 20% of car engines in the U.S. are turbocharged, compared to more than 70% in Europe. It is estimated that tighter emission regulations and eventual higher gasoline prices will drive double digit growth for turbochargers in the years to come. Honeywell is one of only a handful of companies that have deep experience and scale in mass producing high output turbochargers.

In addition to new product offerings, Honeywell has become a much more efficient manufacturer over the past 10 years. A number of operating initiatives (Six Sigma, Honeywell Operating System, Functional Transformation, etc.) implemented since 2003 have pushed the company's key operating metrics toward the upper end of the peer group. On a cumulative basis, the rewards have been transformative. By keeping costs – such as labor – relatively flat, the company generates operating leverage that magnifies returns. Operating margins have grown from 7.6% in 2004 to 17.3% in 2016.

Honeywell has been a very cautious buyer of new businesses. It focuses on easy-to-integrate, small businesses that have the potential to deliver immediate and significant cost savings. Every acquisition must meet a highly specific checklist with an emphasis on integrating the business. On average, Honeywell has paid around 12 times earnings for 70 acquired companies and, correspondingly, profits have tripled.

Based on the financial characteristics outlined, we have assumed that Honeywell can grow its revenue at an average annual rate of over 2.5% over the next decade. At this pace of growth and given improved operating efficiency, we believe cash flow margins can average nearly 19%. Accordingly, our stock valuation model indicates a long-term annual rate of return of approximately 6%.

Baxter

Baxter International Inc. {BAX}

Baxter International provides a broad portfolio of essential renal and hospital products, including acute and chronic dialysis, IV solution and administrative sets, infusion systems and devices, nutrition therapies, biosurgery products, and inhaled anesthetics as well as pharmacy automation, software, and services.

The company's global footprint and critical nature of its products and services play a key role in expanding access to healthcare in emerging markets and developed countries. Baxter is among the global market share leaders in all its businesses with manufacturing in 20 countries and products and systems sold in 100 countries. The company's good manufacturing scale with worldwide distribution and product breadth in injectable and inhaled therapies makes the firm a vital supplier to caregivers.

Baxter offers the broadest selection of pre-mixed drugs in the industry and continues to expand revenue from innovative drugs, such as inhaled anesthesia.

Baxter's medical delivery and dialysis businesses are made up of a diversified mix of both basic and innovative products. The company maintains large global market shares in mature but stable products, such as IV administered therapies and nutritional solutions. Baxter offers the broadest selection of pre-mixed drugs in the industry and continues to expand revenue from innovative drugs, such as inhaled anesthesia.

The consumable and medically necessary nature of Baxter's products provides relatively consistent revenue and operating cash flow.

In 2015, Baxter completed the spin-off of its BioSciences business that specializes in the treatment of rare blood disorders, which allowed better strategic focus and capital allocation on its core hospital products and services. Baxter has created a strategy centered on portfolio optimization, operational excellence and strategic capital allocation. The company's plan to continue to drive sales growth and profit margin improvement includes management's focus on the anticipated growth of several high margin businesses, the launch of new, high margin products and services as well as exiting certain low margin businesses. The company also will continue to reduce its manufacturing footprint and capture additional supply chain efficiencies.

Baxter's main challenge is continuing its efforts to contain costs in the healthcare industry in general, which may exert pricing pressure on medical products. In addition to government regulation, managed care organizations' purchasing power has strengthened due to their consolidation into fewer, larger organizations with a growing number of enrolled patients. Quality control is also a risk factor. Product recalls can harm relationship trust, and lost market share is hard to regain.

We believe Baxter can generate long-term revenue growth in the 3-4% range with cash flow margins over 20%. Based on these assumptions, our valuation model indicates Baxter's current stock price offers a long-term average annualized rate of return of 5%.

Procter & Gamble Company {P&G}

Procter & Gamble sells its products in more than 180 countries and territories and is the largest consumer products company in the world. The company's diversified portfolio of branded products includes major brands, such as Tide, Oral-B, Crest, Gillette, Pampers and Olay. P&G has built or acquired a portfolio of 21 brands, each of which generates between $1 billion and nearly $10 billion in revenue each year. P&G has three times more billion-dollar brands than its next largest competitor and more than most of its remaining competitors combined.

P&G's brands often hold top market share positions in their respective categories. Its sheer size confers economies of scale benefits in manufacturing and distribution, giving it a strong bargaining position versus its retailers.

P&G's success has been built on a long-standing business model: Discover meaningful consumer insights as to their needs and wants through deep consumer research and understanding, translate those insights into product innovation and create compelling marketing and advertising to convince consumers of the superior performance and value of P&G products. P&G's brands often hold top market share positions in their respective categories. Its sheer size confers economies of scale benefits in manufacturing and distribution, giving it a strong bargaining position versus its retailers.

P&G is coming off a major five-year transformation that has led to a 70% reduction in brands and $10 billion in cost savings. Management is now focusing on using part of its improved cash flow to increase innovation and marketing spend on core brands to accelerate organic growth.

P&G now has a refocused and strengthened portfolio of 10 core product categories. Innovation and a more disciplined emerging market expansion strategy will continue to be a driving force behind P&G's long-term growth outlook.

Productivity continues to be a key focus. P&G is beginning a new $10 billion cost savings program from new efficiency measures and reduced overhead costs. Management aims to generate savings by simplifying its manufacturing and distribution processes. Better collaboration between segments should fully exploit the company's purchasing and advertising advantages and offer further economies; however, we expect the majority of these savings will be reinvested in product innovation and marketing to combat increasing competition in the consumer products industry.

P&G's largest potential risk is its exposure to rising commodity costs. If combined with lower shelf prices, higher commodity costs can cut into margins. P&G has significant market share and usually controls one of the top spots in most categories and segments in which it competes; but then again, the company does face strong competition from branded and store brand offerings. These competitors have at times been very aggressive in discounting and promotional activity. P&G realizes the need to defend its market share and has been more uncompromising in its pricing adjustments and promotional activity in its major categories and geographic markets.

Given P&G's concentration in mature markets and increasing exposure to faster growing developing markets, we have assumed the company can grow revenue just under 3% annually with cash flow margins of approximately 22% over the next decade. Based on these assumptions, our stock valuation model indicates P&G's current stock price offers a long-term average annual rate of return of approximately 6%.

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