Fourth Quarter Letter 2015

PERSPECTIVE

Through the third quarter, U.S. companies spent over a half a trillion dollars buying back their own shares. That is the highest amount of stock buybacks for the first three quarters of a year since the record year of 2007, the year before the financial crisis. With interest rates low and cash levels near records, the use of cash or debt to finance buybacks is widespread. Surplus cash on the balance sheet gets almost non-existent returns and depresses a company's return on assets.

A stock buyback, also known as a "share repurchase," is a company buying back its shares in the marketplace. By buying back its shares, a company is investing in itself. Between 2005 and the end of 2014, over 90% of the companies listed in the Standard & Poor's 500 Index for the past decade spent $3.7 trillion – or 52.5% of net income – on share repurchases. Another 36% of net income was distributed via dividends.

Corporations can do five things with cash: pay down debt, make acquisitions, reinvest in the business through capital expenditures, pay dividends or buy back stock. Stock repurchases boost earnings per share by simply reducing the number of shares, even if total earnings don't change. With Board approval, buybacks are entirely at management's discretion. The announcement by management that the company has "authorized" a dollar amount of share repurchases does not necessarily mean it will be enacted. It simply means the company, at its discretion, may buy shares in the open market up to the authorization amount.

We view a company's allocation of its hard earned cash as a critical determinant of value and management stewardship.

Are buybacks good for shareholders? The answer depends. Theoretically, managements should pursue buybacks if they offer the greatest return potential for shareholders – a better return than a company could get from expanding operations, investing in the brand or any other use the company has for cash. Buybacks can be a relatively low-risk use of surplus cash. Re-investing cash in R&D or making an acquisition can be risky, particularly if the company does not have a good track record in allocating capital.

Buybacks, sometimes referred to as “financial engineering,” have drawn criticism when companies invest too much in purchasing shares and too little on longer-term growth. Critics also state that buybacks can be used by management to increase compensation. All else equal, the reduction in shares increases earnings per share, which is often used as a criterion to trigger performance bonuses and stock grants. A buyback announcement can boost share prices temporarily in the short term, allowing managements to exercise options if prices exceed the grant strike price.

Since interest paid on debt is tax-deductible and interest earned on cash is taxable, some firms are incented to increase debt to finance buybacks. The additional indebtedness adds to the risk, particularly if interest rates were to subsequently rise.

What is Delta’s view of stock repurchases and how do we determine whether the action is in the best interest of shareholders? We favor repurchases if our companies’ share prices are selling at substantially below their intrinsic value. We view a company’s allocation of its hard earned cash as a critical determinant of value and management stewardship. It is important to remember that share repurchases by a company are not always a wise allocation of capital. This is amply demonstrated by the fact that companies bought back a record amount of stock in 2007 when prices were high, but bought back few shares in 2009 when prices were cheap. Buybacks are appropriate when shares are truly undervalued and if higher growth alternatives are not available. They should not be used to avoid the heavy lifting required to successfully invest in innovation, skilled workforces or essential capital expenditures necessary to sustain long-term growth.

December 16, 2015

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 Procter & Gamble Company { PG }

Procter & Gamble is the largest consumer products company in the world with a wide geographic reach and diversified portfolio of brands. The company’s major brands include such well regraded names as Tide, Oral-B, Crest, Gillette, Pampers and Olay. P&G has built or acquired a portfolio of 25 brands that generate between $1 billion and over $10 billion each in revenue per 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 success has been built on a long-standing business model: Discover meaningful insights into consumer needs and wants through deep 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, as well as a strong bargaining position versus its retailers.

P&G's growth has struggled since the 2008 recession as consumers continue to shift from premium products to cheaper alternatives. Though P&G performs well with a sizable selection of value products, it earns the bulk of its revenue and profitability from premium category goods. P&G has exacerbated its sales volume declines by maintaining its premium pricing, while more aggressive competitors discounted prices and increased promotional activity.

Today, P&G is focusing on 10 product categories with about 65 brands. In response to recent sluggish growth, the company has shed around 100 brands and is reducing overhead and achieving cost efficiencies to the tune of $10 billion. The 65 brands the company will keep account for 95% of its profits. In addition, the company is taking a more disciplined approach to growth in its emerging markets. Focusing on markets with existing infrastructure and scale should allow P&G to gain share and improve efficiencies in manufacturing and distribution.

P&G has shed around 100 brands and is reducing overhead and achieving cost efficiencies to the tune of $10 billion.

P&G is specifically targeting fewer, but larger, product launches. An example is the rollout of Tide Pods introduced in 2012. With significant advertising support, it has grown to 6% market share of the laundry segment.

P&G tapped David Taylor, a 35-year company veteran, to succeed A.G. Lafley as CEO on November 1, 2015. Taylor headed up the health care business since 2013 and is expected to continue implementing the playbook P&G has been operating under the past few years. Lafley will continue to serve as executive chairman to ensure a smooth transition.

Given P&G's strategy of extracting costs from its operations, while fueling investments in product innovations that resonate with the consumer, we have assumed the company can generate 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 7%.

Wal-Mart Stores, Inc. { WMT }

Founded in 1962, Wal-Mart began with a single store in Rodgers, AR. Today it has grown to more than 11,000 retail stores in 27 countries serving more than 250 million customers a week. The company is the world's largest retailer operating in a variety of formats including discount stores, neighborhood markets, super centers and grocery stores. Wal-Mart, with $480 billion in annual sales, possesses tremendous scale and leverage to extract the most favorable terms possible from suppliers and vendors. The company is very adept at using its cost advantage to maintain low price leadership and keep constant pressure on competitors.

Competitive advantages in retail are hard to come by. Wal-Mart is increasingly caught in the middle between dollar stores and more expensive department stores. The industry is no longer fragmented for easy share gains particularly within the domestic market. Amazon has changed the distribution channel in general merchandise with a direct-to-consumer model. Another competitor, Costco, derives nearly all of its profits from membership fees so it sells food at essentially zero economic profit. In addition to online and warehouse/retail competitors, “Dollar” stores with improved product offerings are blanketing regions with stores, clustering units sometimes less than a mile apart.

In response to the expanding competitive challenges, Wal-Mart is beginning an aggressive investment program after years of underinvesting in e-commerce and over engineering cost reductions in its core business. Through fiscal 2017, Wal-Mart will spend $2.7 billion to boost pay for store employees. This move should reduce turnover and allow greater staffing within departments to improve customer service. The company is redesigning stores with a standard of CFF (Clean, Fast & Friendly). A total of 67% of U.S. stores achieved this designation in October, 2015, up from just 16% in February. Store pick-up in grocery continues to be a priority with the company expecting to be in approximately 20 markets this year and another 20 by next year. Store managers are using more and better data to decide which products stay on shelves and where to remove clutter. Employees also are starting to restock during the day, when customers are most likely to notice missing items rather than late at night.

Wal-Mart, with $480 billion in annual sales, possesses tremendous scale and leverage to extract the most favorable terms possible from suppliers and vendors.

International will continue to be an opportunity for growth. The company’s strategy is centered on increasing penetration in its existing markets and entering new, emerging markets. Wal-Mart executes this strategy by acquiring local retail chains and then improving operating efficiency to reduce pricing and drive sales volumes. The International division’s limited scale results in less efficiency and profitability than in its U.S. operations. Operating internationally can be more challenging than domestically as the company has to adjust to different cultures, laws and varying degrees of economic development. However, we believe strategic international expansion remains a viable growth alternative for Wal-Mart.

Global e-commerce sales surpassed the $22.2 billion mark, a 22% increase over last year. Over 8 million items are found on Walmart.com with 75% of those items not found in retail stores. The company has increased its e-commerce efforts by launching @WalmartLabs (a testing platform for online selling), hiring strong talent in social and mobile media, and inviting online shoppers to pick up purchases from local stores.

Overall, we expect Wal-Mart’s growth will be less than its historical average due to the large size of the store base, full penetration of the domestic market and more intense competition. We expect Wal-Mart’s improved U.S. distribution and better inventory management to generate average cash flow margins of over 6%. Based on these and other assumptions, our stock valuation model indicates Wal-Mart’s current stock price offers a long-term average annual rate of return in excess of 10%.

Emerson Electric Co. { EMR }

Emerson, formed in 1890, has grown from a regional manufacturer of electric motors and fans into a diversified global technology company with operations in more than 30 countries. The company operates in a wide variety of businesses including diagnostic controls and measurement products for industrial processes, data network power, manufacturing automation and climate technologies. Headquartered in St. Louis, MO, Emerson has over 235 manufacturing locations worldwide with 55% of sales outside North America.

Although Emerson generated over $24 billion in global sales in 2014, it has the flexibility of a smaller, more nimble player due to its regional operating structure. Emerson innovates, engineers, sources, manufactures and sells within each region of the world. What is made in Asia is sold in Asia, what is made in Europe is sold in Europe and what is made in the U.S. is sold in the U.S. Sales in emerging markets have expanded to 37% of sales. Emerson's overall strategy is to provide differentiated products with leading technology, volume leverage and pricing, which results in higher profit margins than competitors and most industrial companies.

Emerson's competitive advantages stem from its vast installed base, which increases customer switching costs.

The company operates in five main business segments. Emerson's largest and most profitable segments, such as process management and climate technologies, turn customer reliance on total system solutions, which combine Emerson equipment with human and knowledge capital, into higher margin sales and more entrenched customer relationships. Emerson's competitive advantages stem from its vast installed base, which increases customer switching costs. In addition, its manufacturing scale provides a cost advantage versus most competitors.

In process management (44% of total company profitability), Emerson offers leading technology and a complete system solution that allows the company to earn profit margins comfortably above peer levels. Customers from various industries, including power, oil and gas, chemical and pharmaceuticals, pay a premium for Emerson's complete front-to-back automation solutions. Although others have subsequently developed competitive products, Emerson's strategy is to develop a unique technology, implement it at the beginning of the cycle, establish a lead and expand market share.

Emerson's next phase of growth will involve a broader push into higher margin solutions and services sales. Its strategy is to move from being a high-quality supplier of engineered products and components to collaborating with customers to better understand their operations and what they value. This information is valuable for Emerson as it leads to innovative technology and a tailored software solution for the customer. Emerson also benefits from high-margin recurring software sales as companies typically update their system software every few years. The company is increasing its investments in engineering and development spending as well as sales, marketing, customer service and project management globally to enhance its relationship with customers, support product development and increase market penetration.

Emerson is still a cyclical company and is currently facing challenges within its portfolio of businesses. The company is spinning off its network power segment due to a difficult operating environment with cutbacks in key end markets and increasing competition. The company is also looking to dispose of other component part product lines that have become commoditized with heavy competition leading to lower profit margins. Current cyclical challenges that may last longer than expected include falling oil prices and a sharp decline in developing market economies. Growth in process management is dependent on oil and gas production, and Emerson generates 37% (and growing) of its overall revenue in developing markets.

We believe the company's extensive installed base and long-term customer relationships should provide support for its stated transition to a services and solutions strategy. We expect Emerson will grow revenues low single-digits on average with cash flow margins of 18% over our 10-year modeling period. Based on these assumptions, our stock valuation model indicates Emerson's current stock price offers an average annual long-term rate of return of approximately 11.5%.

Comcast Corporation { CMCSA }

Comcast is the nation's largest cable provider offering a range of information, entertainment and communication services to residential and commercial customers. The cable segment's network is complete with video, high speed internet and voice services that can be accessed by 55 million homes and businesses in 39 states representing more than 40% of all U.S. households. The company's NBC Universal business is a leading entertainment and media company that develops, produces and distributes news, sports and entertainment for global audiences.

The cable segment is mature with subscriptions for video declining and high-speed internet access slowing. With its cable footprint essentially built-out requiring only periodic upgrades, return on investment and free cash flows have increased. New competitive forces are emerging with Netflix, Amazon, Google and other technology companies offering online and mobile platforms to watch video. Comcast leads the cable industry in innovations and has aggressively responded to these new entrants by launching its own online offerings, Internet Plus, Xfinity on Campus, Stream and X1, the company's premium TV Everywhere platform. A critical Comcast defense is its industry-leading internet speeds. With the continuing growth of online and mobile video and gaming, data usage-based pricing could become another driver of Comcast's revenue growth in the future, especially as data usage increases exponentially. Comcast's network architecture allows it to add capacity to meet customer speed demands at a far lower cost than competitors.

> **With its cable footprint essentially built-out requiring only periodic upgrades, return on investment and free cash flows have increased.**

In 2013, the company completed the full acquisition of NBC Universal (NBCU). In two years, Comcast has significantly improved this collection of businesses, which includes cable networks, NBC broadcast stations, movie studios and theme parks, providing adequate growth and good cash flow. The NBCU segment has several popular cable channels, such as USA

Network, CNBC, Golf Channel, E!, Bravo and NBC Sports. Comcast believes it can transform the entertainment unit into a compelling multi-media juggernaut with the parent company's ample capital, scale and digital know-how. Its central focus will be sports. The NBC Sports group has a new $100 million production facility; and with investments in the Olympics, NASCAR, Premier League soccer, NCAA football and NFL football, it is betting it can boost fees and advertising. Sports are "must see" live events. Comcast is using sports to promote its interactive services, such as TV Everywhere, so customers never have to miss any action and to help prevent cord cutting.

Comcast has many positive attributes including recurring and predictable cash flows and competitive advantages, such as substantial scale and a fully built-out network. The significant capital investment needed for a new entrant to build a competing network serves as a barrier to entry and limits the ability to compete on price. With its network complete, Comcast can add new subscribers and improve the speed capacity with only modest additional costs while increasing overall return on investment and efficiency.

Comcast continues to operate exceptionally well with good growth and robust free cash flow. The company has a number of responses to the various competitive threats it faces; however, we believe it is prudent to expect modest revenue growth and a gradual reduction in operating margins over our forecast horizon. Our stock valuation model estimates a long-term annual return for Comcast of approximately 10% based on its current stock price.

Dated: December 16, 2015

Specific securities were included for illustrative purposes based upon a summary of our review during the most recent quarter. Individual portfolios will vary in their holdings over time in relation to others. Information on other individual holdings is available upon request. The information contained herein has been obtained from sources believed to be reliable but cannot be guaranteed for accuracy. The opinions expressed are subject to change from time to time and do not constitute a recommendation to purchase or sell any security nor to engage in any particular investment strategy. Any projections are hypothetical in nature, do not reflect actual investment results and are not a guarantee of future results and are based upon certain assumptions subject to change as well as market conditions. Actual results may also vary to a material degree due to external factors beyond the scope and control of the projections and assumptions.