Second Quarter Letter 2014

PERSPECTIVE

Asset allocation is the exercise of diversifying a client's portfolio among various asset classes, such as stocks and bonds, in some combination to minimize volatility and risk. Although volatility year-to-date has been benign this year, the Great Recession provided a powerful example of the true benefits of diversification. In 2008, if you had invested in just one asset class, such as the S&P 500, your investments would have been down by 37%. This loss would have been mitigated by incorporating some percentage of bonds in the portfolio. In 2008, the Barclay's Aggregate Bond Index, which measures the performance of investment grade bonds in the U.S., was up 5.24%.

A diversified portfolio's rate of return will typically exhibit less volatility than an undiversified portfolio because different asset classes respond differently to changes in the economic environment. During periods of extreme market volatility, the prices of stocks and bonds quite often move in opposite directions. This counterbalancing effect reduces the volatility in a diversified portfolio's returns; however, the reduction in volatility comes at the expense of somewhat lower long-term rates of return.

At Delta, we believe that diversification is a very important ingredient to long-term investment success. Diversification will not ensure gains or guarantee against losses, but it can help to minimize exposure to risk in any one area, expand the ability to benefit from opportunities in the global economy and reduce the overall volatility of the portfolio. Diversification is achieved through asset allocation, which is determined by a client's tolerance for volatility, financial goals, income needs and time horizon.

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We achieve diversification in a number of ways. Delta's stock portfolios typically consist of 30 to 35 stocks that offer a broad array of exposure to different industries, geographic regions and varying correlations with the business cycle. Investing across industry sectors limits the possibility that a downturn in any one industry might significantly reduce the long-term growth potential of your portfolio. Conversely, it also helps ensure that your portfolio will benefit if a particular sector or business strongly outperforms. We generally limit our position size on any one company to 4% at cost and, by and large, do not invest more than 8% at cost in any one industry.

Most of our client portfolios contain a mix of stocks and bonds. Historically, bonds are considered less risky than stocks because bonds pay a pre-determined level of interest, and issuers promise to repay the debt in full to bondholders at maturity. Stocks over time generate higher rates of return than bonds but with much greater volatility. The average annual gain of the S&P 500 Stock Index from 1980-2013 was 13.9% versus the Barclay's Aggregate Bond Index return of 8.4%. To illustrate the relative volatility, stock returns during this period ranged from a low of -37.0% in 2008 to a high of +37.6% in 1995. Bond returns ranged from -2.92% in 1994 to +32.6% in 1982. History has demonstrated that it takes a longer time horizon to successfully invest in stocks than bonds. This difference is due to the lack of a final maturity in a stock, as well as the residual claim on the underlying asset's profits.

Diversification is an important tool to reduce risk and volatility. Establishing and maintaining your strategic asset allocation are among the most essential criteria for successful investing. Our goal in managing investments for our clients is to provide a competitive, long-term return while minimizing the risk of achieving that return. We have achieved this goal, in part, through a thoughtful approach to diversification, by investing in individual securities and through an asset allocation that is tailored to our clients' needs.

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.

CSC

Computer Sciences Corporation { CSC }

Founded in 1959, Computer Sciences (CSC) is a global provider of information technology (IT) and systems consulting. CSC helps clients use IT more efficiently in order to improve their operations and profitability, focus on core competencies and achieve improved business results. The company's international delivery capability, deep talent pool and long lasting relationships help generate stable and recurring revenue. Approximately 75% of revenue is from long-term contracts, and client retention is over 80%.

CSC is cutting costs, improving efficiency, rationalizing and standardizing its service offerings and instituting an accountability-based management system.

CSC is one of the major IT service providers to the federal government. Its public sector division contracts with the federal government on sensitive projects requiring a high degree of security clearance, competency and the ability to navigate the labyrinth of governmental contracting and accounting standards. Traditionally, only a few domestic providers can meet these hurdles although recently the competition has increased. Although government budgets have been under pressure, computer systems and IT infrastructure will need to be maintained and even grow in some areas.

The industry is changing, in part, because companies are shifting from pricey proprietary computer networks to remote cloud computing services. CSC was slow to adapt to these changes. As the industry shifted to smaller, specialized cloud contracts, CSC continued to pursue high-risk, high-profile mega deals. These deals became commoditized and serviced by low-cost providers. The industry continues to be challenged by the growth and increasing sophistication of sizable, low-cost firms from India.

Due to these issues and inconsistent performance, CSC recently brought in a new management team led by Mike Lawrie, a highly regarded and experienced CEO. He quickly and methodically implemented a strategic plan to improve the company's revenue and profit growth. The company is cutting costs, improving efficiency, rationalizing and standardizing its service offerings and instituting an accountability-based management system. The company's profitability has subsequently improved.

CSC's consultancy business is positioned to capitalize on growth sectors, such as healthcare, chemicals and security.

To drive more profitable growth, CSC is increasing its large employee base in low cost regions and utilizing those employees more effectively. CSC is focusing on higher-value clients and reducing its reliance on commoditized offerings. The company's consultancy business is positioned to capitalize on growth sectors, such as healthcare, chemicals and security. In addition, CSC is developing next-generation offerings, such as cloud computing and cyber-security services. These offerings are in their early stages, but we believe CSC has a good initial position in the industry.

Overall, with mature and competitive industry characteristics, we expect growth to be modest during our forecast period; however, we believe management's new strategic directions will lead to a more efficient CSC and result in higher profitability and free cash flow. Based on these assumptions, our valuation model indicates a long-term average annual return of 10%.

Nestlé Good Food, Good Life

Nestle { NSRGY }

Nestle is the largest food and beverage company in the world with operations spanning the globe. The company also possesses the largest cache of food and beverage brands in the business with entries in many major categories, including beverages, dairy products, confectionery, pet food and infant nutrition among others. The company has been very successful at establishing positions in growing product lines, generally through acquisition, and then nurturing those brands to further prominence.

The company's advantages include its possession of leading brands, significant economies of scale and an extensive global distribution network. Nestle controls the #1 or #2 global market share position in the majority of its categories, which generally have low, private-label competition. The company's unmatched investment in research and development has driven innovation, particularly toward differentiated health and wellness benefits. Nestle's strong brand support should continue to strengthen its market position. Buttressing these advantages is a good management team that has developed strong positions in products with better growth and margin potential.

Nestle has an unmatched geographic footprint. The company's decades-old global operations and investments have created meaningful scale and dense distribution networks and have established brand reputation in 140 countries, including a significant presence in faster growing emerging markets. The company has operated in most of its countries and markets for generations with consumer and supplier relationships dating back decades.

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Nestle faces its share of challenges, including a sizeable footprint in Europe, which we expect will continue to struggle economically. The proliferation of low-price store brands continues to be a threat industry-wide, especially in periods of economic weakness. Consumers are increasingly gravitating towards natural and organic foods. They are also buying more fresh foods, as opposed to frozen, processed and packaged foods. This has had a negative impact on all food manufacturers, including Nestle.

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A company-specific challenge for Nestle is also one of its strengths. Nestle's size could cause the company to become too slow to fully take advantage of opportunities or resolve missteps in execution. Nestle addresses this challenge through management improvement programs aimed at continually improving global operating efficiency while allowing for decentralized management in localized regions. While decentralization may lead to operating inefficiencies on occasion, it provides important flexibility in a company of incredible size. Nestle still maintains industry-leading growth and possesses an enviable profit margin.

Given our expectations for worldwide growth in food and beverage markets and Nestle's mix of faster growing and high margin categories, we believe Nestle can grow revenues over 4% annually over the next decade and maintain its operating margin at 15%. We believe Nestle will be able to offset pricing pressures from both major retailers and increased competition through the continued implementation and execution of a number of cost efficiency programs adopted in recent years. Based on these assumptions, our stock valuation model indicates Nestle's current stock price offers a long-term average annual rate of return of approximately 7%.

General Mills, Inc. { GIS }

General Mills is a leading consumer foods company with a large stable of branded products, including breakfast cereal, refrigerated dough, baking mixes, snack foods, ice cream and yogurt. The company's portfolio of leading brands includes Cheerios, Fiber One, Green Giant, Pillsbury, Progresso, Betty Crocker, Nature Valley, Haagen-Dazs and Yoplait.

General Mills controls the #1 or #2 market share position in almost every product category in which it competes. The company has developed its leading market share positions by continuously investing to improve established brands and by creating new products. The management team, led by CEO Ken Powell, is very adept at growing new products and building brand equity through heavy consumer-focused marketing strategies.

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General Mills generates approximately 70% of its revenue and profits in the mature U.S. market. Though growth should be moderate, the company's focus on product innovation and brand support through heavy advertising should continue to protect its market share position. The company's leading product offerings should benefit from consumer trends, such as increased meals at home, and a growing health and wellness focus. In addition, the company is expanding internationally in both developed regions, such as Europe, and faster-growing markets, including China and Latin America. General Mills has good revenue and earnings growth potential in these regions as the company further develops its distribution network and expands its product offerings.

General Mills has a culture of operating efficiency. The company takes a holistic company-wide approach to improving productivity and reducing costs throughout its entire supply chain. These continuous cost-savings measures allow the company to invest in its brands for future growth and maintain industry-leading profitability and free cash flow.

In addition, the company is expanding internationally in both developed regions, such as Europe, and faster-growing markets, including China and Latin America.

The company faces its share of challenges, including retail customer consolidation and strong competition in the packaged foods industry. Retail consolidation has given General Mills' customers greater control over product pricing and store shelf space. In addition to branded competitors, the company faces increased competition from private-label products and natural, organic products. General Mills' sizable international expansion plans, including infrastructure build-outs, new product introductions and acquisitions, must be executed effectively to generate adequate returns on invested capital.

Given General Mills' concentration in mature markets, combined with increasing exposure to faster-growing emerging markets, we have assumed the company can grow revenue in the low-single digits annually over the next decade. At this pace of growth and given the company's intense focus on reducing costs, we believe cash flow margins can average 19% over this period. Based on these assumptions, our stock valuation model indicates General Mills' current stock price offers a long-term average annual rate of return of just over 7%.

P&G *Proctor & Gamble { PG }*

Procter & Gamble sells its products in more than 180 countries and territories and is the largest consumer product 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 25 brands that each generates between $1 billion and over $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 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.

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The company has been in a difficult operating environment 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. In June 2013, after four lackluster years, the former CEO, A. G. Lafley, returned as a transitional leader and is expected to hold the job for three to four years.

Lafley is refocusing efforts on the U.S. where more than half of P&G's profits are generated and is undertaking a more disciplined approach to growth in emerging markets. In addition, there is a re-emphasis on innovation, which is important to justify the company's premium pricing. 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.

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To improve profitability and help fund growth initiatives, P&G is undertaking a $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.

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 over 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 7%.

3M Company { MMM }

3M is a global diversified technology company with a presence in the following businesses: industrial equipment, healthcare, consumer and office products, safety and graphics and communications. It is one of the more defensive of industrial companies because of its strong exposure to more stable healthcare, consumer and security markets and geographic diversity. The company manufactures over 55,000 products from more than 200 manufacturing facilities in over 40 countries. Consumables comprise 90% of sales and include such products as abrasives, adhesives, laminates, passive fire protection, dental products, electronic component materials, car care products, electronic circuits and optical films.

Over 33% of 3M's revenue comes from new products developed in the most recent five year period.

The company is well positioned to benefit from several themes, including efficiency in healthcare, water and air quality, aging populations, industrialization in emerging markets and alternative energy and renewables. 3M has consistently reported best-in-class operating margins over the past 20 years. The company's premium margin is largely attributable to its vertically integrated operations, lean manufacturing processes and differentiated brands, such as Scotchguard and Post-it Notes.

In 2013, over 63% of sales were international. The company has a global manufacturing base with 43% of its plants outside of North America. Sales in developing countries have grown at a 10% compound rate over the past decade. Localized production and distribution have enabled the company to earn higher margins in emerging markets than in domestic markets.

3M's culture of innovation has carved a moat around its businesses. Research and development (R&D) expense as a percent of revenue is 5.6% versus the median 3% for many industrials. The company's goal is to increase R&D as a percent of sales to 6% by 2017. The investment in R&D has paid off. In recent years, 3M launched over 1,300 new products and won 2,400 patents. Over 33% of its revenue comes from new products developed in the most recent five year period, up from 21% five years ago. The company's goal is to have 40% of revenue derived from new products by 2015.

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3M positions its R&D and capital expenditure spending with a long-term focus. To encourage development of new products, 3M researchers are allowed 15% free time to work on whatever projects they wish. Over time, 3M has been able to develop not only improvements in products currently being sold but also create entirely new product areas. We expect this practice to continue, with the effect of protecting profit margins through higher-priced new product introductions.

With strong consumer brands, a track record of innovation and low-cost manufacturing, 3M has competitive advantages over smaller industry players. Given these advantages and our assumptions, we believe that 3M's present stock price offers the potential for an average annual long-term rate of return of greater than 7%.

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