Second Quarter Letter 2016

PERSPECTIVE

Investor sentiment was dramatically different in the opening months of 2016 when there was a confluence of bad news around the world that shook investor confidence. Many investors were worried that the U.S., in recent years the strongest-performing economy, was about to be dragged down by global forces, including the rise of the dollar. The factors pointing to a global recession included everything from low commodity prices (indicating low global demand) to slowing growth in China exacerbated by debt. China's debt has gone from 155% of the size of its economy in 2008 to 260% at the end of 2015. Some market pundits and the financial press were espousing the view that the risk of a recession was rising.

By March, the S&P 500 sharply reversed itself and was up over 6%, as the U.S. economy remained in relatively healthy shape compared to the rest of the world. Not only was the U.S. healthier relative to other global economies, stocks offered a return haven from low bond yields. Bill Gross, noted bond investor of Janus Capital, tweeted that "global yields were the lowest in 500 years of recorded history."

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On June 23, voters in the United Kingdom voted by a narrow margin to leave the European Union in a referendum known as BREXIT. Equity markets were up prior to the vote (in anticipation of a "Remain" win) and then down across the globe (on the reality of an "Exit" win) as many competing perspectives of BREXIT created uncertainty that translated into volatility. The reaction in the short term was based on speculation while the long-term consequences were unknown. BREXIT underscores the fallacy of trying to extrapolate the recent past into the future.

"Recency bias" is the tendency of investors to think that recent trends and patterns will continue in the future. This behavioral bias affects investor sentiment in both up and down markets, and it can cause investors to react to short-term trends as opposed to focusing on economic value. In times of heightened stock market volatility, investors don't always react rationally, and emotions can be exacerbated by an around-the-clock financial news cycle. Given the complexity of the global economy and the efficiency of how data and information are disseminated, the stock market follows a random pattern in the short run.

In addition to BREXIT, the factors supporting the "down" market of the winter months of 2016 are still present. In June, the World Bank lowered its global growth forecast from 3.3% to 2.4%. China's imports of raw materials are down, which further weighs on beaten down commodity dependent economies such as Brazil and Australia and calls into question China's official 7%

growth target. Central banks in Japan and Europe continue to push interest rates lower, even to the point of being negative, to stimulate demand. U.S. companies are facing a trifecta of accelerating wages, sluggish demand and low productivity. Labor productivity, the amount of goods and services employees produce per hour worked, fell to a 0.6% annual rate (versus an average growth rate since WWII of 2.2%) in the first quarter.

The factors supporting the "up" market of the spring months include a declining unemployment rate below 5%, a benign 1% inflation rate both as of May and a bounce in oil prices, up to over $40 a barrel. Oil is still considerably cheaper than the $114 price per barrel peak in June 2014, benefitting both consumers and manufacturers.

Predicting short-term stock market swings, in our opinion, is nearly impossible. Although the market rallied in the spring and reversed the dismal start to the year, the potential for future up or down swings remains – that is why the theme of our first quarter letter bears repeating in this second quarter letter. Volatility is an integral part of investing, and a focus on the short term or extrapolating current trends misses the mark. Investors can be their own worst enemy, selling at the times of greatest panic or buying in times of market exuberance. We believe the focus should be on investments with sustainable profits and cash flow achieved over time. Delta's value proposition is a long-term disciplined approach that emphasizes value investing and the economic worth of each investment in contrast to market timing or trading in reaction to the short-term swings of the market.

June 24, 2016

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.

Nestlé 150 Years of Good Food, Good Life

Nestlé { NSRGY }

Nestlé is the largest food and beverage company in the world, with operations spanning the globe. The company is a leading player in several categories including beverages, dairy products, confectionery, pet food and infant nutrition among others. More than 20 of Nestlé's brands generate in excess of $1 billion each in annual sales. 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. Nestlé controls the No. 1 or No. 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 products. Nestlé's strong brand support should continue to strengthen its market position. The substantial marketing support and the market share positions give Nestlé a relatively strong position to negotiate with retailers for primary shelf space in stores strengthening its competitive position.

Nestlé is a core supplier to grocery stores across the globe, and its distribution network is extensive. The company's decades-old global operations and investments have created meaningful scale and dense distribution networks and have established brand reputation in 189 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.

Nestlé 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 industrywide, 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 trend has had a negative impact on all food manufacturers, including Nestlé.

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The company is heavily exposed to emerging markets to the tune of an estimated 45% of sales. Cyclical headwinds in these regions have contributed to recent underperformance. The company's focus on local distribution networks, manufacturing and raw material sourcing should position Nestlé to be competitive and responsive when these markets recover.

A company- specific challenge for Nestlé is also one of its strengths. Nestlé's size could cause the company to become too slow to fully take advantage of opportunities or resolve missteps in execution. Nestlé 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. Nestlé still maintains industry leading growth and possesses an enviable profit margin.

Another challenge for Nestlé is that it generates more than 98% of its sales outside its home base of Switzerland; thus there is a significant exposure to fluctuating foreign currency rates. A strengthening in the Swiss franc is likely to negatively affect topline performance and profitability.

Given our expectations for worldwide growth in food and beverage markets and Nestlé's mix of faster growing, high margin categories, we believe Nestlé can grow revenues more than 4% annually over the next decade and maintain its operating margin at 14%. We believe Nestlé 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 evaluation model indicates Nestlé's current stock price offers a long-term average annual rate of return of approximately 6.5%.

Duke Energy { DUK }

Duke Energy is now the largest electric power company in the United States after its 2012 merger with Progress Energy. The merger with Progress strengthened Duke's core Carolinas market and expanded its coverage territory into Florida. Duke now generates and distributes electricity across a broad region encompassing parts of the Carolinas, Florida, Ohio, Indiana and Kentucky. The utility has a diversified customer base (residential 33%, commercial 33%, industrials/textiles 24% and wholesale 10%). As a result of the merger, Duke now has greater operating efficiencies, a more diverse and flexible power generation fleet and a more diverse geographic footprint.

In August, 2014, Duke sold its non-regulated Ohio assets to Dynegy for $2.8 billion in cash, a level well above investor expectations. Returns in Ohio were low, and revenues had been steadily declining. Under legislation in effect since 1999, Ohio customers could switch electricity providers at any time to capture the benefits of lower rates.

As a result of the sale to Dynegy, 95% of Duke's power portfolio operates in a regulatory approved monopolistic environment. In a regulated market, state commissions are responsible for approving a utility's rate base and allowable operating expenses. While rate base rulings are supposed to be in the public interest, commissions must also allow a utility to earn an adequate rate of return to compensate it for investment in plants and environmental improvements. With guaranteed returns and low variability in earnings, regulated entities such as Duke carry less risk than those operating in a competitive market. Regulated utilities, however, lack upward pricing power absent a new rate setting proceeding with state regulatory commissions.

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Consequently, state regulatory commissions are an important factor in securing an adequate return on investment. Based on recent decisions, the commissions in North and South Carolina appear to be reasonable and balanced about the need for compensatory return on capital and the public's desire for low electric rates. Duke should benefit from favorable regulatory regimes in the Carolinas and Florida. Regulatory risk remains a key uncertainty, particularly given Duke's aggressive capital expenditure plans during the next few years.

Duke will continue its aggressive capital expenditure plans at least for the next few years, which should help growth assuming constructive rate case outcomes allow adequate returns. The company is taking advantage of historically low interest rates by issuing debt to finance modernization programs. However, construction costs for new power plants have increased markedly since 2000. The risk from cost overruns is that regulatory commissions may not allow a rate increase on cost overruns.

In August 2014, the North Carolina legislature passed the Coal Ash Management Act of 2014. The law requires closure of all coal ash basins in the state within 15 years, all of which are leaking contaminants into underground water. It is likely that the cleanup will result in higher costs for Duke's 3.2 million North Carolina customers. Duke is working on an environmental remediation plan, which must be reviewed and approved by North Carolina state environmental authorities.

The International division operates power generation facilities and serves customers for electric power and natural gas primarily in Latin America. Management recently announced plans to sell the International division. Current estimates peg the value at approximately $1.5 billion or roughly $2 per share.

Successful completion of a relatively aggressive capital expenditure program should enable the company to achieve revenue growth in the low single digits. Our valuation assumes Duke achieves favorable regulatory outcomes on future rate cases. Demand challenges and rising costs are expected to pressure profit margins offset by operating efficiencies and better generation flexibility post-merger. We anticipate a long-term annualized rate of return on Duke's stock of approximately 6%.

Microsoft

Microsoft Corp. { MSFT }

Microsoft is the leading provider of operating systems for PCs and the world's largest software maker by revenue. The company's products include Windows operating systems for personal computers, servers, server applications, Office business solution applications, video games and its online search offering, Bing. Microsoft is an early provider of cloud-based solutions that provides customers with software, services and content over the internet. In addition, Microsoft designs and sells hardware, including the Xbox 360 entertainment and gaming console and assorted PC hardware products.

Satya Nadella is the third CEO in the company's history. Since becoming CEO in February 2014, he has sought to change the company's culture and product development. He has overseen several critical product launches, including Windows 10, Office 365 and the Surface Pro 4 tablet. New management's goal is to transform Windows into a ubiquitous cross-device operating system from a singular focus on PCs. He also plans to focus investments on core productivity experiences and platform development for Windows, Office and business systems, such as Azure and SQL Server.

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In the past, Microsoft's legacy products, such as Windows and Office, gave the company high profit margins and cash flow to reinvest in non-core businesses. The migration of consumers away from the PC to mobile devices and the development of open source software applications threaten to erode the dominance of Microsoft's core operating system and Windows applications. Google has established itself as the leading online search player and has used its position to branch out into direct competition with Microsoft with its Chrome internet browser and operating system software. On the mobile operating system front, Apple's iPhone operating system and Google's Android platform have become the market leaders.

To its credit, Microsoft continues to innovate, especially in its core businesses. The real question is how durable are its major franchises, Windows and Office. Both have varying degrees of durability, although the PC-based Windows is the most vulnerable due to the rise in mobile devices. Office appears to have the greatest longevity and even some growth potential by mixing local and cloud applications. The new Office application, Office 365, is available as a subscription model, perfectly suited for a cloud future. Cloud-based Office 365 can reduce piracy, a significant opportunity. It is estimated that Microsoft received only a fraction of the revenues it is due in China as a result of piracy. With Office 365 distributed on the cloud, subscriptions can automatically renew each year and updates to software can be automatic. Every time a user opens the program they will be running the latest version and billed accordingly. Documents will be saved to Microsoft's cloud storage system by default, so documents and personal settings are remotely accessible.

Microsoft must continue to innovate as its core businesses mature and decline. Microsoft recently made its largest acquisition in its history by acquiring LinkedIn for $26.2 billion. The company believes the professional social network can open new platforms for Office and Dynamics (enterprise software for reporting and controls).

In the past, several of Microsoft's investments (Bing, Nokia and Zune) have been outside of the company's core and, though we don't doubt the company's ability to invest its way to a viable business, the amount of capital committed in these efforts in the past made a compensatory return more challenging. Microsoft's transformation to a cloud-based software company should allow it to lower its distribution costs and focus on its core strength, serving enterprise (business) customers.

For legacy businesses such as Windows and Office, the company is moving from a transaction model to a subscription model, extending the lives of these businesses, expanding the market and setting the stage for a stronger recurring revenue structure. Updates and software fixes will be easier, and there will be a higher capture of revenue as leakage from piracy improves. We anticipate that Microsoft will continue to develop and acquire a wide range of technologies and products, some of which will be outside of its core, and will experience relatively lower long-term returns on capital. Our valuation model indicates that at its present stock price, Microsoft offers a potential of an almost 10% annual rate of return.

L'ORÉAL ***L'Oréal { LRLCY }***

L'Oréal is a leading manufacturer in the world cosmetics market with a presence in 130 countries on five continents. The company has excellent market share positions in most regions of the globe. The scale and breadth of L'Oréal's brand portfolio and geographic reach gives it sustainable competitive advantages. The company's success over many years is attributable to the development of premium products, global branding and a number of product innovations geared to targeted regions.

Much of L'Oréal's recent growth has been organic. A key driver of growth has been the impressive amount spent on advertising and promotion (30% of sales versus 25% on average for the sector). By marshalling its resources on a limited number of brands, the company can launch new products using the identity of an established brand. A healthy 3% investment in research and development has also contributed to growth. With 23 research centers around the world, the company's research is focused on "universalizing" beauty. Universalizing beauty means adapting it to local tastes and culture and making it accessible to all. As a result of its robust R&D budget, L’Oréal launches an average of 200 to 300 new products a year, representing 15% of sales.

L’Oréal’s new markets will remain a key growth driver going forward, and beauty as a category is well positioned to benefit from growing consumer spending in many of these regions. Europe and North American markets are mature with high penetration and well established competitors. In contrast, the company is seeing growth in newer markets where the middle class is growing and eager for high quality cosmetic products. L’Oréal is targeting to more than double its customer base from 1.2 billion to 2.5 billion over the next 10 to 15 years by focusing on product categories that are popular in emerging markets.

China remains a major area of growth in emerging markets and now represents 8% of sales (L’Oréal’s third largest market globally). L’Oréal is the number two cosmetics player in China, with leading positions in skin care, make-up and colorings. It only recently launched its hair care products there, which now comprise 25% of the Chinese market. With these new category introductions, L’Oréal may become China’s leading cosmetics player over the next few years.

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The company maintains worldwide pricing for its products, so profit margins in emerging economies are comparable to those produced in developed ones. A sustainable competitive advantage is the company’s ability to cover all price points with a range of brands. L’Oréal can establish a presence in an emerging economy by introducing lower price point brands without damaging the later introduction of its higher priced premium brands.

We believe L’Oréal can continue to grow its revenues despite its exposure to mature North American and European markets due to growth potential in emerging markets. Profit margins are likely to be constrained by competitive pressures as well as possible inflationary cost increases in the developed economies. These limits should be offset by cost efficiency measures in marketing and supply sourcing as L’Oréal consolidates the operational aspects of its disparate businesses. We believe L’Oréal will be able to maintain long-term operating profit margins in the middle teens and earn a long-term rate of return of over 5%.

Avery Dennison Corporation { AVY }

Avery Dennison is the leading manufacturer of pressure-sensitive labeling materials. The company is also one of the world’s largest producers of retail apparel ticketing and branding systems, radio frequency identification (RFID) inlays and specialty tapes.

Avery has a significant global presence with approximately 200 manufacturing and distribution facilities in 50 countries and product sales in 89 countries. Nearly 75% of revenue is derived from international markets, including emerging markets.

The company maintains a dominant market share position in its two main businesses: pressure-sensitive materials and retail branding and information solutions. Avery's specialization, superior product offerings and effective customer service should continue to strengthen its relationships in these businesses. Although both business segments have reached maturity in developed markets, Avery continues to expand its already significant international presence, particularly in Asia where it has had a large presence since 1995. Long term, these economies should continue to expand, and the demand for packaged goods and apparel will likewise expand. In addition to adding new regional partnerships, Avery grows as its multi-national customers expand into new, faster growing regions.

Avery's size gives it a narrow competitive advantage. The firm's extensive global distribution network and customer relationships further strengthen its advantages over its competition, particularly with large consumer products manufacturers such as P&G. These relationships can be "sticky" due to the tailored servicing involved. Meeting specific customer specifications and formats increases switching costs.

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Pressure-sensitive materials is Avery's most important business segment and contributes nearly 75% of company profits. Avery is more than twice the size of its nearest competitor. The company's manufacturing scale enables Avery to obtain operating efficiencies that generate a premium profit margin over its competitors. Avery's technical and engineering expertise have led to innovative new products, such as clear film labels and thinner, more flexible labels that conform to oddly-shaped consumer packages and bottles. This market is a faster growing segment with premium operating margins. The proprietary technology is important to consumer products manufacturers for brand awareness and product appeal on the shelf. We expect the company will continue to benefit from the growing shift from glue-applied paper labels to flexible, clear film labels on consumer products packaging and bottles.

Given Avery's concentration in mature markets and its increasing market share in faster growing emerging markets, we have assumed the company can grow revenue approximately 3.25% annually over the next decade. At this pace, given the company's operating efficiencies, we believe cash flow margin can average approximately 11% during this period. Based on these assumptions, our stock valuation model indicates Avery's current stock price offers a long-term average annual rate of return just over 6%.

Dated: June 24, 2016