The Outlook: Sept. 27, 2018

The market "thinks" about Lockheed.

We will eventually fail, as investors, unless we understand the true nature of two things: the U.S. economy; and the market.

- The true nature of the U.S. economy is that it's the wonder of the world: the most powerful creator of financial well-being in history. Its power comes from free market competition; the rule of law; limited taxation, regulation and government interference; and the total personal accountability of business leaders for results.

- The true nature of the market is that short-term price movements are completely dominated by the behavior of speculators, hence often have no rational connection to what the economy and the business sector are actually doing; but in the long run what the economy and businesses actually do completely dominates the market and the speculators, not the other way around.

This afternoon has given us more than one clear example of this "nature of the market." Let's look at one of them.

Lockheed: 3 Years

There is Lockheed Martin's last 3 years in the market. After a wonderful, long climb of 80% in 2 years, the market's speculators pounced on it this year, pounding it down from $360 to $295 per share: an 18% "loss." Why? Nothing had changed in Lockheed's business operations, which continued to report quarter after quarter of rock-solid results. Nothing had changed for its flagship product—the F-35 fighter—except for the better, as both U.S. and international orders gradually accelerated, and as the F-35 kept excelling

in its combat training tests. But two pieces of news, earlier this year, were enough for the speculating crowd. First, the U.S./North Korea summit meeting and supposed sharp turn toward peaceful behavior in North Korea; and second, an announcement by France and Germany that they planned to develop a European alternative to the F-35, which is the most advanced fighter in the world by a long shot. Down went Lockheed in several sickening plunges between February and August.

"No rational connection to what is actually happening," was our remark about the nature of the market and its frequent behavior. All that mattered to speculators, when North Korea made friendly noises at the summit, was that a vague impression had been created: the impression that one of the world's bad guys was suddenly turning good, so the world's good guys would eventually spend less on weapons. It does sound pretty silly when we say it that way, doesn't it? But when people form themselves into crowds—or even that peculiar subset of "crowds" known (and dreaded, in the business world) as "committees"—<u>they always think less clearly, not more clearly</u>. And the business of the market's great crowd of speculators really isn't thinking, but reacting to impressions faster than the rest of the crowd. That "North Korea turnaround" impression was a nice, strong one as far as the speculating crowd was concerned. The "new European fighter jet" impression was only half that strong—which made sense, because it was straight out of the Twilight Zone, when it came to connection with reality. The announcement by the leaders of France and Germany that they would commence building their own version of the F-35 triggered jaw-dropping disbelief, even in Europe, among everyone who knew the slightest thing about the vast time, money and sophistication behind the F-35 . . . and the near-total lack of such things in France, Germany or anywhere else in Europe, when the subject is defense spending and military preparedness. Of course, the nature of politicians is to say things to create quick impressions in their own favor, which makes the "European F-35" announcement much more understandable—but not the least bit more realistic.

None of that disconnection with reality mattered . . . for a while. Down went Lockheed in February, then down and down again—until the strength of those "impressions" petered out, then finally vanished like fog in a morning breeze. Lockheed went about its business, and quarter after quarter let the market know that its solid progress was marching on. The fog was gone by the end of June . . . and the market's speculating crowd decided that this company—valued well under the market, performing well in its business operations, and paying a high and rising dividend—might be worth a higher price. Hence the 17% rise in 3 months, capped off today by Lockheed's announcement of its latest dividend hike, a 10 percent hike, bringing its yield to 2.6%; and at the same time the addition of another $1 billion to buying back Lockheed stock in the market. Cash, returned to investors, is a piece of reality which the market finds particularly hard to ignore for very long.

And so the story of 2018 for Lockheed (and its real investors) has been, so far . . . a roller-coaster ride. The market's vast speculating crowd did its thing: placing fast, temporary bets on how the same crowd would probably react to "impressions." Lockheed did its thing: working; building; improving; and rewarding shareholders. And we investors—understanding both Lockheed as an operating business, and the market as an unthinking crowd—did our thing: holding on, and buying more when possible. That's why we've done so well with Lockheed for several years now. We don't think the ride is over. We think it has a long way yet to run.

Outlook Capital Management, LLC
125 S. Wilke Road, Suite 200E
Arlington Heights, IL 60005

847-797-0600

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