SANDHILL
INVESTMENT MANAGEMENT

July 6, 2020

To our stakeholders-

As I stated in my March 25th letter: **Quality wins. Every time.**

When you invest in the U.S. equity market, the market and the assets you hold will go up over time. The reason that you choose an "active manager" such as Sandhill is to responsibly outperform the market over long periods of time and add real value to your financial well being.

In remaining committed to the U.S. equity market, there will be periods of great distress and dislocation. Through the first half of this year, the COVID-19 pandemic and social unrest brought great distress and volatility to the U.S equity market. At the end of March, we as a country were scared and dealing with a dangerous unknown. Markets became disorderly and both individual investors and institutions started dumping both stocks and bonds at rapid measure.

In that same March 25th letter, I said, "I have not seen this good an investment climate since the 2008-2009 financial crisis.". This turned out to be true as the market has rallied 40% from the March low. There were opportunities in the stock and bond market that we will not see again for some time. The market rarely offers second chances on such compelling values.

At Sandhill, we had everyone work remotely except for the investment team – so I am going to call them out. Rick Ryskalczyk, Mark Larry, Aaron VandeGutche, and I were at the office every step of the way from March 17th to May 12th.

There were a number of dynamics at work. First, we knew the world had changed and we had to change with it. Second, we knew that most of our companies and their business models would withstand the short term effects of COVID-19 even if their share prices were temporarily marked down. Third, we owned some assets that would not do well in the the near and medium term in the COVID-19 era and had to be sold quickly. Fourth, we knew there would be some compelling investment opportunities.

As we intensely bought and sold stocks and bonds over a six week period, the backbone of our strength was that we knew that – on the whole – we held high quality assets that would withstand the severe economic shock of the COVID-19 pandemic. We were never "in trouble". We knew and have always understood that preservation of capital is just as important as capital appreciation.

For the first six months of 2020, Sandhill's Concentrated Equity Alpha (CEA) composite returned -1.5% net of fees vs. a return of -3.5% for the Russell 3000 Total Return Index. We are very pleased with this result for our clients.

Sandhill's long term track record

When determining the quality of an investment manager's work, the long term track record is the most revealing and informative data point. Here is Sandhill's return against our benchmark over the longer term:

	Trailing 3 Year	Trailing 5 Year	Trailing 10 Year	Since Inception
CEA composite net of fees	+43.2%	+80.8%	+311.6%	+369.2%
Russell 3000 Total Return	+33.3%	+61.3%	+261.8%	+282.1%

These performance numbers demonstrate the value of long term investment.

Strategic pivot

The effect that COVID-19 will have on our economy is significant and meaningful. COVID-19 has cut down on both mobility and consumption. Everything from the ability to manufacture (that requires large groups of people in close quarters), meet with clients, fly on an airplane, dine out, and go to a football game are all materially affected. In essence, COVID-19 has placed a huge drag on our economy and dampened demand across numerous industries. This slowdown of our economy is real and will last for at least 1-3 years. This should provide a hint of caution to investors.

We put every penny on the table at the end of March. That was a good decision. However, given the sharp move upward from the March lows, the cash position in the CEA composite has been increased from 2.1% on 3/23/20 to 12.7% at the close of business on 6/30/20. In a nutshell, we went from offense to defense quickly. As I have said, we like volatility on **both** the downside and upside – it creates opportunities to buy, sell, add, and trim positions when the market is extremely oversold or overbought.

In addition to raising cash to put to work in the second half of this year, the financial profile of our portfolio companies is very strong. We sold any companies that had dicey balance sheets or cash flow issues. We buttoned up very quickly and are in the enviable position of owning a basket of companies with rock solid balance sheets and (on the whole) strong free cash flows. We have adapted well to our current environment.

Why is the market up?

I have been asked this question frequently over the past month. The answer – the Federal Reserve and the power of the printing press. The Fed's mission to inflate asset prices is intentional – but not without cost.

Before this pandemic plays out, my guess is that the Federal Reserve will add somewhere between $4 trillion and $7 trillion to its balance sheet. That's a fancy way of saying the Fed is printing money and increasing the national debt to inflate asset prices. This debt will be handed down to our children and grandchildren. Jerome Powell and the Fed have done a great job in both acting quickly and substantially to keep enough liquidity in the U.S. economy so that we don't have a prolonged recession or depression.

We have two conflicting forces – the massive amount of money injected into our "system" that has to go somewhere (like the stock market) vs. our clearly diminished economy. With the market relatively unchanged for the year, you could call it a standoff.

How will it play out?

There are three scenarios:

Optimistic: We find a medical solution to COVID-19 in late 2020 or the first half of 2021, our economy finds its footing, and we are off to the races.

Base case: We get the pandemic under control and learn to live with it but a medical solution that can be delivered at scale is further out than we think. The economy muddles along.

Pessimistic: COVID-19 has a significant recurrence in the fall/winter and we need to once again close down parts of our economy after the reopening. The economy falters.

Predictions are a dime a dozen these days. I will say that I think our CEA and Corporate Bond portfolios are well positioned for all three scenarios and we will act accordingly.

The drive to digital

Tech stocks and the NASDAQ have done extremely well this year. It is clear that COVID-19 has accelerated the world's ongoing adaption of technology to run both commerce and define how we live. It is also clear that tech stocks are close if not soon to enter a bubble. Watching some of the premier up and coming tech names trade at 20, 30, or even 40 times **revenue** is staggering. Certainly, shades of the 1999 tech bubble are being recreated today. While there remains a myriad of ways to continue to profit from the digitization of the world, this is now a time to be careful as well. There can be a difference between a good company and a good investment.

Sandhill outperformed the market in the first half of the year in large part due to our tech holdings. Portfolio holdings such as Adobe, Fortinet, and Ceridian all had a strong return in the first half of the year. As of 6/30/20, our CEA composite had a 33.9% weighting in technology. I like the **amount** of our tech exposure and our individual holdings.

When there is a medical resolution to COVID-19, I believe that capital will flow out of tech and return to other industries.

The bond market

I said in our January newsletter that the bond market was a "lousy deal". This proved to be true as the bond market came unglued in March and bond prices fell sharply. The bond market went from a lousy deal to a screaming deal in a matter of two weeks. We gorged on bonds of credit worthy companies with big, fat yields to maturity.

That window is now closed and the bond market is once again a lousy deal.

With the Federal Reserve setting interest rates at near zero, it is now almost impossible to get a decent yield from a solid credit. This is a problem for savers and retirees.

I have come to learn that the bond market gives you one or two good shots a year to buy bonds at attractive prices – and you need to act quickly and with confidence when the bond market is under duress. I have also learned that you need to be patient and wait for the right opportunity.

For the first half of 2020, Sandhill's Corporate Bond composite returned +1.0%. The duration of our composite is a short (and safe) 2.5 years with a yield to maturity of 3.0%. By comparison, the three-year U.S Treasury note yields 0.2% - so the average yield to maturity of our Corporate Bond composite is 2.8% better than the comparable treasury note.

Fixed income alternative

As short-term interest rates are near zero and the bond market is once a gain a lousy deal, Sandhill is on the cusp of introducing a new fixed income/alternative product. We have done six months of due diligence. I am satisfied this will be a sound investment. It is a private Real Estate Investment Trust (REIT) that has a 6.19% yield net of fees. The underlying assets are industrial properties. Rick and I have personally visited some of these properties. The dividend is paid monthly and is 65% -70% tax sheltered because of the depreciation of the underlying assets.

We look to launch this product in August. That said, I am going to remain flexible on our launch date as I want to be comfortable that the markets remain settled and we continue to make progress on COVID-19. Importantly, the REIT can be custodied at TD Ameritrade. This product will be offered to accredited investors only.

Assets under management

As of 6/30/20, assets under management were $1.73 billion. This is an increase of $114 million from the start of the year.

Sandhill additions

I would like to welcome Paul Stancs to Sandhill. Paul has been named a director and has joined our sales group. Paul joins us after nine years at Fisher Investment and brings a great breadth of knowledge of the investment industry to Sandhill.

I would also like to welcome Eric Hanfland. Eric has been named an assistant equity analyst and recently graduated from the University at Buffalo. Eric will be helping the investment team with coverage of our portfolio companies.

I would like to welcome Max Wojtczak to our operations team. Max has been named an operations associate. Max recently graduated from University at Buffalo and will be working in the technology/systems management area of our business.

I would like to welcome Ariel Bauerlein to our customer service team. Ariel has been named a client service associate and came to Sandhill from Citizens Bank. Ariel will be working in Tina Hassler's customer service group. The goal of this group is to provide proactive and seamless customer service to our clients.

Going forward

Since Sandhill's inception on March 1, 2004, we have managed our client equity capital through the worst stock market decline since the Great Depression – the 2008–2009 financial crisis (down 54%) - and the Covid-19 shock of 2020 (down 34%).

Yet, even with those two shocks, we sit here sixteen years after inception with our CEA composite up 369.2%.

There is great value in patient, value-added long-term investing.

I hope this letter finds everyone well and safe.

With regards,

Edwin M. "Tim" Johnston III
Founder, Managing Partner