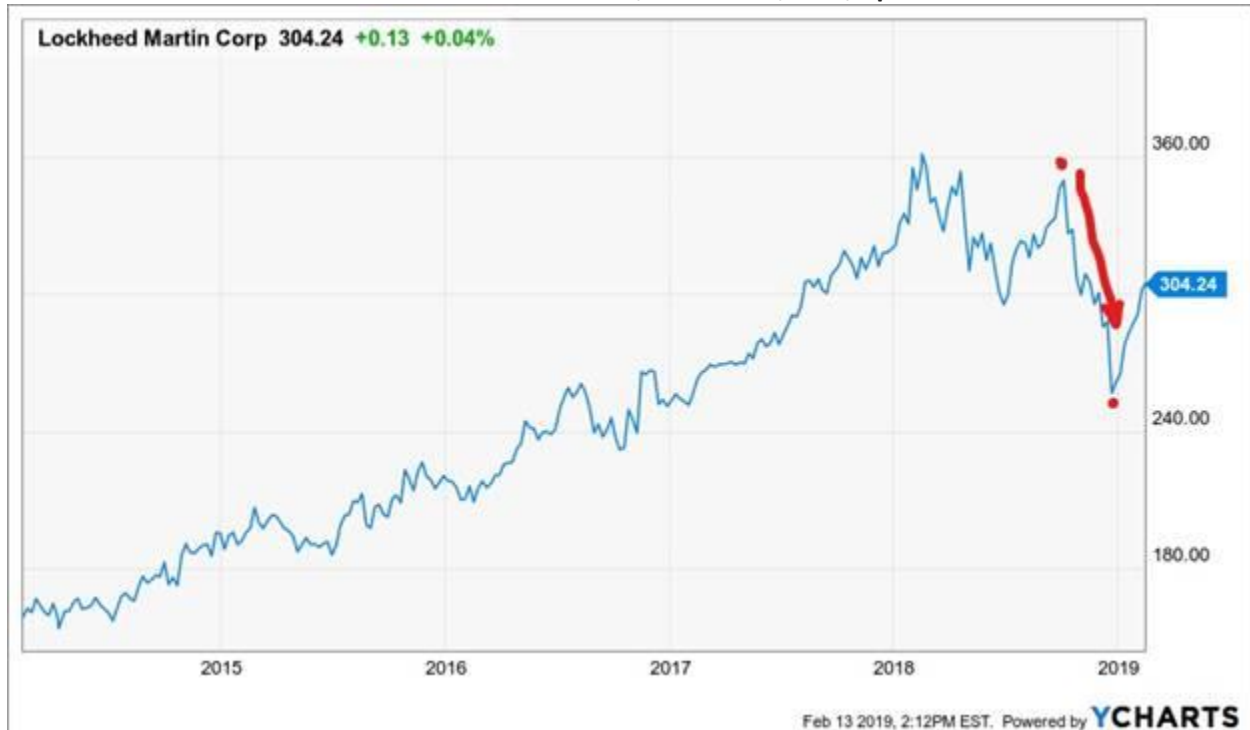


## The Outlook: Feb. 13, 2019

### *Finding the truth about things: a story from Lockheed Martin.*

We'll tell a story about Lockheed Martin, today; but it's also a lesson about the sometimes-colossal difficulty of finding out the truth about things—in the investment world and every other world, unfortunately. Let's keep this picture of Lockheed's last 5 years—and especially its last 4 months, over there at the right—in our minds as we hear the story.

**Lockheed since Oct. 4: first, down 30%; now, up 24%.**



A couple of days ago an aerospace and defense expert, Loren Thompson, wrote an article in Forbes titled, “F-35 Will Cost Less to Operate than Older Fighters. Here’s Why Some Policymakers Don’t Get That.” Mr. Thompson was reacting to just one of the complaints and criticisms of Lockheed’s F-35 fighter which have cropped up regularly, year after year, since the F-35 concept got its first dollar of funding from the Pentagon at least 15 years ago. Plenty of those criticisms have always come from the military itself, “inside the Pentagon,” which naturally tends to shake investor confidence in Lockheed and its flagship product. It’s one thing when an anti-defense politician slams a program, we naturally think, but when the military itself throws the stones, surely there must be real fire beneath that smoke. Yes . . . surely we can trust such inside sources to tell us “the truth?”

We know the answer, don’t we? But before giving Mr. Thompson the floor, let’s take a quick walk back through history all the way to the Civil War, Abe Lincoln, and the Union’s Army of the Potomac—which spent two solid years being beaten and humiliated by Robert E. Lee’s Confederate army before finally beginning to even the score at Gettysburg in 1863.

Mr. Lincoln had the same problem as us investors, but infinitely more important: he had to find the truth behind the Army of the Potomac's many disasters, which meant finding the truth about the battlefield behavior of many Union generals at or near the top of that Army. Now the story gets startling, for modern observers accustomed to a modern military code which expects generals to keep their mouths shut, more or less, except up and down the chain of command, which ends at the top with the President. Many if not most Union generals in the Army of the Potomac seemed to follow a different code: "After a battle, tell my side of the story to my favorite newspaper as fast as possible." Of course, "my side of the story" very often meant "lie up, down and sideways about what I did, if I did badly; and put the blame on other generals or the army's commander-in-chief . . . especially if any of them belonged to the other political party." So within hours of each setback, a blizzard of competing stories telling "the truth" about what happened showed up in the Washington press. It was one more cross to bear for Mr. Lincoln, who carried a lot of them during those 4 years. In the end, the only way he could "find the truth" was by sizing up each general, face to face, and making his own gut-level judgment about them. Thankfully, he was very good at that.

Lockheed has put 15 years and many billion dollars into making the F-35 the world's best fighter—so much better that the best an enemy can offer would literally stand no chance against the F-35, which is designed to destroy an enemy "before they know we're here." That goal, of course, makes the F-35 a major "weapon for peace" in the hands of the U.S., like any "unanswerable" weapon. Yet the flow of criticism from inside the military has been constant . . . only beginning to ebb this last year or two, with 500 F-35's now in service and an accumulation of "unanswerable facts" building up, concerning the jet's performance. Mr. Thompson addressed one of the ongoing critiques of the F-35's cost: it's "sustainment costs," meaning how much money it costs to operate it and support it, once it's in the field. The Pentagon has an office called "Cost Assessment and Program Evaluation" (CAPE), which has been the source of this flavor of the "F-35 Costs Too Much" critique.

In a nutshell, Mr. Thompson destroyed CAPE's critique by simply explaining its distorted statistics and methods. CAPE's methods (which appear to be as set in stone as most bureaucratic methods) ignore the vastly increased effectiveness of the F-35 (meaning "cost per dollar of benefit" is far lower than simply "cost"); ignore the vastly lower combat loss rates expected from the F-35; ignore the "age cost curve" of all new fighters for the past 50 or 60 years, which make for higher sustainment costs during the initial few years, much lower costs during the next couple of decades, then gradually rising costs as the plane enters "old age;" and, finally, ignore the hidden costs of older fighter-jet models, which are well known among their users, but not captured by CAPE's statistics and formulas.

Of course, the \$64 Question is this: "Is Mr. Thompson the only expert who grasps these obvious points, or are they just as easily understood by the CAPE and other military "insiders" who've been carping about the F-35, year after year?" We know the answer, naturally. And the one-word answer to the next question, "But why?" is surely the same today, as it was for the Army of the Potomac's "extraordinarily political" generals 150 years ago: "politics." In the U.S. Army, assignment to the Pentagon has always been considered a vital hole to punch in an officer's career ticket . . . and has also been considered, by the Army's real soldiers, to be an unfulfilling, torturous way to spend a tour of duty. But like every giant organization, the Army contains born bureaucrats as well as born soldiers—and to bureaucrats, currying the support of politicians (who'd like to score political points by hammering some aspect of the military) comes as naturally as taking coffee breaks.

How, then, can we investors find the truth behind such blizzards of misleading critiques and deceptive statistics? It's not easy at all. But like Mr. Lincoln, we always do well to ask what our common sense and

“gut instincts” may be telling us. On the one hand we’ve had a stream, year after year, of “insiders and bureaucrats” pointing out warts and flaws in the F-35, ranging from the fairly minor “sustainment cost” critique to the bottom-line “lousy fighter-jet, colossal waste of money” critique. On the other hand we have Lockheed Martin, which has made generation after generation of the best combat jets in the world for the U.S., and which aimed very high indeed with the F-35 with respect to its superiority over the rest of the world. We also had an impressive lineup of test pilots swearing by the F-35, most of whom said something like, “Once you understand what it can do, it takes your breath away.” Finally, just within the last few years, we’ve had air-combat tests in which the F-35’s “kill ratio” ranged around 7 or 8-to-1 over its adversaries. In recent years, those tests finally began to quiet the bureaucrats. But even before then, the “bad fighter,” “colossal waste” and “sky-high cost” arguments never carried the ring of truth (at least, to our eyes, ears and common sense at Outlook) when examined next to Lockheed’s remarkable record and the consistent praise from the F-35’s early users.

No. Finding the truth about things is seldom easy at all. It takes the same hard work, patience and “common sense” that everything else of value requires. But in the investment business, it’s worth those things, in spades. Lockheed Martin has shown us that for a long time, and we’re rather certain it will continue doing so, for quite a few years ahead.

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