

January 29, 2014

## A Look Back

A recent article that appeared in the Wall Street Journal, dated December 31<sup>st</sup>, 2013 and written by Tom Kilgore and Tom Lauricella best described last year’s investment climate. I have summarized that article and added some thoughts of my own.

In the best year for U.S. stocks since 1995, the smart way to play the markets has been to follow the dumb money. So-called dumb money strategies, which involve buying a plain-vanilla portfolio of U.S. stocks, did much better than the more complex approaches employed by hedge funds and other professional investors. Fueled by easy money from the Federal Reserve and signs of improvement in the economy all the major U.S. stock indices achieved gains approaching or exceeding 30%. Those gains far outpaced the rally predicted by even the most bullish Wall Street strategists. The majority of hedge funds were left in the dust, alongside investors who use "tactical" timing of the markets' ups and downs and those who spread their bets among a wide variety of assets such as commodities, emerging markets and exchanged traded funds.



Despite worries about the outlook for Federal Reserve policy, turmoil in the Middle East and a Federal Government shutdown, U.S. stocks suffered only small and short-lived pullbacks. There were just five selloffs of 2% in 2013, and one decline of 5.8%, which lasted slightly more than a month from May 21 through June 24 amid fears that the Fed would start to “taper.”

Investors normally embrace diversification, believing it adds value. However, this year it had the opposite effect. For example, gold advocates believe it is a good hedge against inflation and rising interest

rates. However, gold declined approximately 29% in 2013, the first annual decline since 2000. As you may remember, we have been quite bearish on the yellow metal and warned our clients to avoid the commodity in our 2012 1<sup>st</sup> quarter letter when gold was selling for \$1,750 per ounce (today's price is ~\$1,249 per ounce). Other commodities which historically have been beneficiaries of global economic growth also suffered. The DJ UBS commodity index dropped 8.6%.

Investors who eschewed the simplicity of buying US stocks and sought more exotic products also underperformed. Hedge funds, particularly those with a long short strategy lagged. That was also the case for portfolios that promise low volatility because they hold so called "defensive stocks," such as utilities and consumer staples. For example, the \$3.9 billion PowerShares S&P 500 low volatility portfolio exchange-traded fund was up 20% for 2013. Not a bad result but well below the leading US stock indices.

The Standard & Poor's 500 Index climbed 29 percent, beating government debt by 32 percentage points, the widest spread since at least 1978, according to data compiled by Bank of America Merrill Lynch and Bloomberg. The 3.4 percent decline in U.S. government debt in 2013 was the first such drop since 2009.

Although the S&P 500, including dividends, advanced 32%, only 4 out of the 10 sectors that comprise that index outdistanced it. The best performer was consumer discretionary advancing by 43%, the other outperforming sectors included industrials, health care and financials. The worst performers were telecom services and utilities advancing 13% and 11% respectively. So it is quite possible that an investor who was underweighted in certain sectors to have materially underperformed the S&P 500 in 2013.

## **2013 Performance**

For most accounts without specific mandates that have been with us for more than 2 years (giving us the opportunity to deploy your capital in a measured approach), we did quite well. Most of these portfolios despite cash positions in the 20%-30% range for much of the year still managed to either keep pace with the S&P or trailed it slightly. Not a bad risk adjusted performance, at least in our opinion.



Our newer accounts underperformed due to the fact that we invest slowly over time. This measured approach to investing obviously works quite well in declining markets, but hurts you in rapidly advancing markets such as the one we have experienced over the past 2 years. However, we think a measured approach to deploying capital over a one to two year period is prudent, especially in light of the huge advance in equities since the March 2009 lows.



The high cash position in many of our accounts was caused in part by the takeovers of Heinz, Saks, and Dole Foods. Once we received the proceeds from the sales of each company, we found it difficult to redeploy that capital into other attractive investment opportunities. However, rest assured once we find an appropriate investment with an attractive risk/reward scenario we will not be shy in using the capital you have entrusted to us.

## A Look Ahead

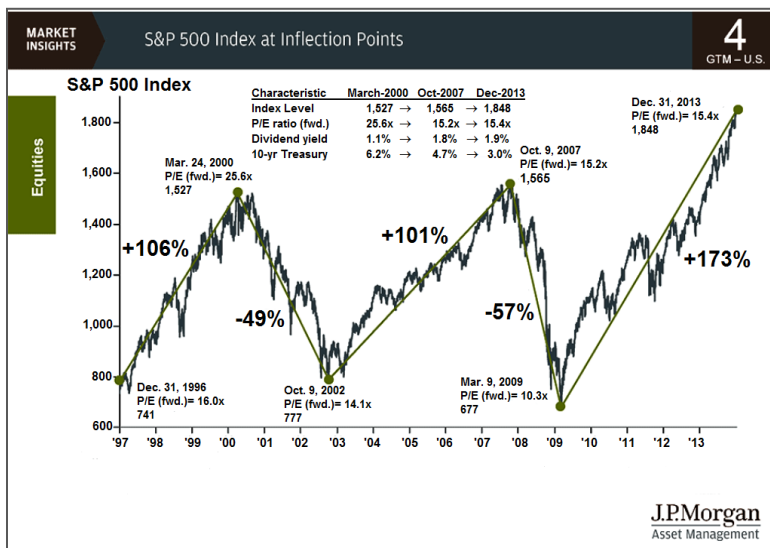
It is hard to believe, but it has been over 5 years since the collapse of Lehman Brothers. Stocks certainly have had quite a run since then advancing by more than 169%, as measured by the S&P 500 from its March 2009 lows. Time has a way of dulling the pain from traumatic shocks such as the most recent financial crisis (making investors less risk averse and allowing new speculative bubbles to emerge). It is clearly more difficult to find bargains today than when stocks like CBS traded for \$6 per share (current price ~\$59.70), or when Saks was trading at \$1.85 per share (recently acquired for \$16 per share). For the moment (at least in our opinion), the days of six or seven baggers are over.



## So Where Do We Go From Here?

Wall Street strategists are the most cautious as they have been in almost a decade after one of the broadest U.S. stock market rallies on record, pushing up price-earnings ratios by about 19%. However we would caution you to take Wall Street strategists predictions with a giant grain of salt. According to Birinyi Associates via the Wall Street Journal the average forecast by Wall Street strategists for the past 13 years has been 10% per year. The actual stock market return has been roughly 3.3% per year (Russolillo & Scaggs, 2013).

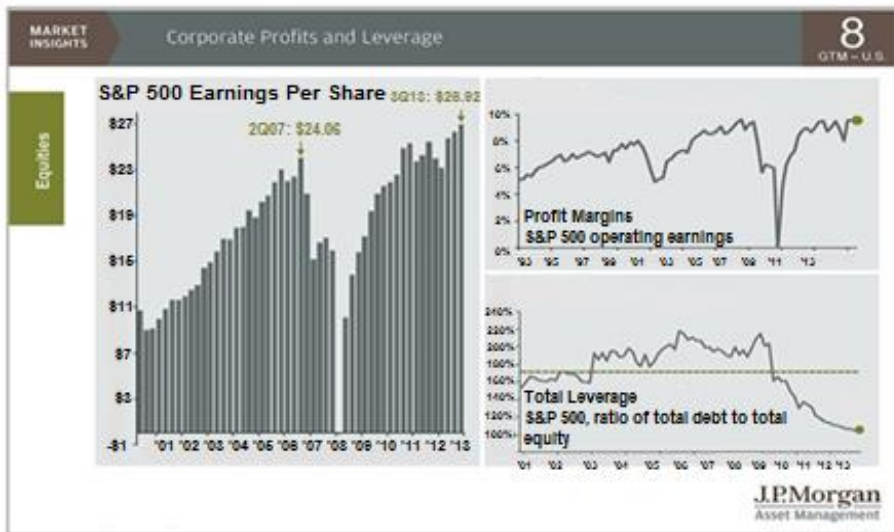
The million (or billion) dollar question is how do you invest in a time of expanding multiples? According to Bloomberg expanding multiples have preceded advances twice as often as they have retreats. Since 1936, the S&P 500 has risen 69% of the time following quarters when valuations widened, the data shows. Furthermore, the average return is 14 percent in years after more than 400 of the constituents in the S&P 500 climbed. Last year 460 stocks rose, more than any year since at least 1990.



In further support of the aforementioned, Morgan Stanley research shows that on the previous occasions when multiples expanded so far and so fast, markets kept rising for at least a year afterwards-and in two cases added a second year of strong gains as well. Share price rallies have a strong momentum effect, and once started can be difficult to stop.

On the other hand over time profit margins show a strong tendency to revert to the mean. At the moment they are currently close to all-time highs. This prompted a number of research analysts to produce research

suggesting that margins may have reached unsustainable levels. If economic growth continues, companies would be forced to hire more workers and perhaps even boost capital expenditures which would be good for the economy but bad in the short-term for profits and the stock market.

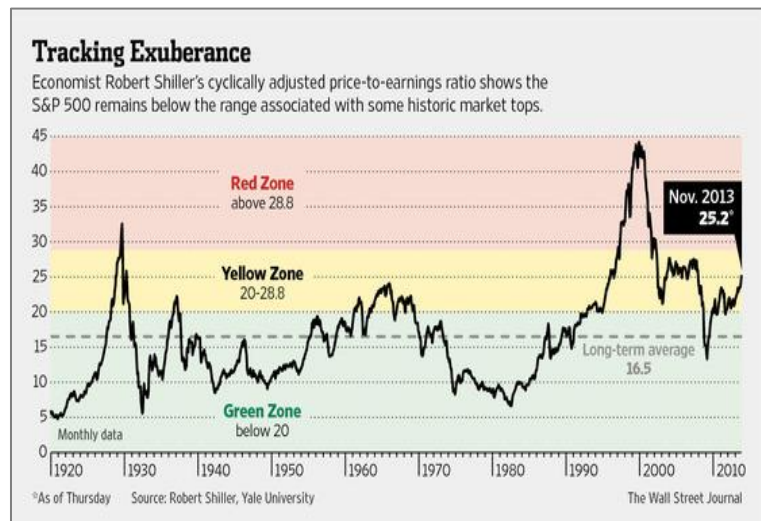


We are of the belief that common stocks as measured by the S&P 500 are no longer on the bargain basement table, as they were in 2009, but are more or less fairly valued. So, investors should temper expectations and anticipate returns that are more in tune with historical norms.

One measure of stock market value which shows that the market is in-fact expensive from a valuation perspective is Robert Schiller's cyclically adjusted

price/earnings multiple. This measure which attempts to adjust for a full economic cycle uses the last decades average earnings (adjusted for inflation) when calculating the P/E ratio for a given company or index. Currently the Schiller method calculates the P/E of the market to be approximately 25x, with the long-term average being approximately 16.5x. However as the chart below illustrates during the internet craze in the late 1990s the P/E ratio using Schiller's methodology was approximately 44xs. Critics of this calculation point out that this method is flawed as profits and economic cycles do not follow exact ten year patterns. Despite the methodologies flaws it is something worth monitoring.

There are other reasons for caution as well. As Ralph Atkins of The Financial Times pointed out in his December 30, 2013 article, "Europe slipped off investors radars as a risk this year, eurozone bond yields fell and the region's equity markets were among the best performing." Andrew Pease who is the global head of strategy at Russell Investments said in the same article, "At the top of the list {of potential problems} is Europe—it has to be. We have learnt over the past three years that the political will to hold it all together is enormous. But politicians will always choose immeasurable future costs rather than significant upfront costs." There are other strategists who are even more pessimistic. Albert Edwards at Societe Generale summarizes his 2014 "biggest risk" scenario as:



*"Re-run of 1996 Asian Currency crisis as Fed tapers and yen devalues. Wave of deflation engulfs US and Europe snuffing out weak recoveries. Full blown currency wars and protectionism to follow?"*

As we have written many times in past letters retail investors are usually a pretty good contra indicator for future stock market performance. According to Avi Nachmany of Strategic Insight total flows into equity funds this year are on course to equal inflows for all of the past four years combined. This is a mixed signal to us as individual investors usually show up to the stock market party toward the top of the cycle. However, investors are still hoarding tremendous amounts of cash, and since people are starting to lose

money in their “safe” bond funds and are currently underweighted in equities by historical standards, there might be significant inflows from performance chasers into common stocks adding significantly more fuel to the fire and keeping the party going for longer than most people expect.

**So, what type of stocks do we think have the capability of doing well over the next couple of years?** During the 1990's large capitalization stocks such as Microsoft, Pfizer, Cisco and Intel to name a few, commanded outsized price/earnings multiples of 40x to 150x. Today, the P/E ratios of these same businesses average approximately 12x, well below the multiples of most of the companies that comprise the S&P 500. These companies also yield 3% or more with the capability of multiple dividend increases over the next few years.

What would we avoid? Currently there are a number of businesses that have captured Wall Street's fancy, each commanding multiples of 100x or more. They include names like Netflix, Zillow and LinkedIn just to name a few. Tesla is another example of a high multiple stock (with no current earnings). The company delivered just 1400 cars in July or about 1% of Ford Motor Company sales for the same month. Today, Tesla commands a market valuation of ~\$21 billion. This is about~ 33% of Ford's market capitalization.



### **Buying Stocks at Record Highs: Will You be Sorry?**

Hedge-fund manager Carl Icahn says he is “very cautious” on U.S. stocks, which “could easily have a big drop” from their new record highs. Ben Inker, a director at asset manager GMO, forecasts that overall, U.S. stocks will suffer losses of 2% annually, counting dividends and inflation, through 2020. Yet billionaire investor extraordinaire Warren Buffett says the U.S. stock market is valued “in a zone of reasonableness.”

### **So who is right?**

In fact, whether stocks are overvalued or fairly priced isn't the question that investors should be asking. Instead, what you need to answer is this: How much can I stand to lose before I will bail out? Experts can't tell you that, but history and what's in your own head can.

David Salem, chief investment officer at Windhorse Capital Management in Boston, says figuring out how much financial misery you can stomach is “the only logical starting point for any comprehensive investment program.” Why? Because even if your assessment of market valuations is perfectly accurate, that won't do you any good if you lack the financial or psychological fortitude to follow through.

Asking the right question is especially important right now. Like a cushy sofa, a bull market can lull even the most anxious people into a drowsy sense of comfort.

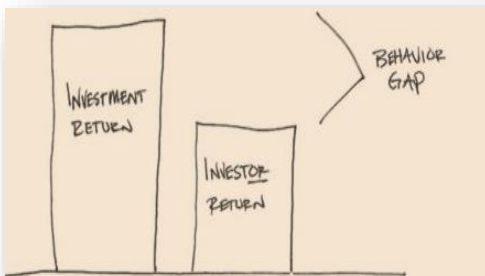
Both the Dow Jones Industrial Average and the S&P 500 set record highs this week. Counting dividends, U.S. stocks have returned 29% so far this year. If returns stay flat through year-end, 2013 would rank as the 19th-best annual return since reliable data began in 1926.

About \$23 billion flowed into U.S. stock mutual funds in the four weeks ended Nov. 13, estimates the Investment Company Institute, after more than \$37 billion flowed out over the previous 12 months....

Mr. Salem has an elegant solution for investors unsure what to do. Stop thinking about how much your stocks might return. Instead, think about risk first. He suggests unwinding, perhaps over a glass of wine, as you ponder your investments. Size up how much money you have in stocks—not in percentages, but in dollars. *“It’s dollars that drive the bailout impulse,”* he says.

Let’s say you have \$400,000 in stocks and stock funds. Between November 2007 and March 2009, U.S. stocks fell 51% and foreign stocks 57%, according to Morningstar. Another such “drawdown” would shrink your portfolio by more than \$200,000. Even if you don’t think stocks are as overvalued as they were in 2007, imagine a drop just half as severe. Can you withstand a short-term loss of \$100,000 in pursuit of longer-term gains?

You can perform the same exercise on any of your assets. Real-estate investment trusts lost 68% between February 2007 and February 2009, according to Morningstar. Gold fell 62% between February 1980 and September 1999, while long-term government bonds lost 21% from July 1979 to September 1981 (Accounting for inflation, and all these numbers look worse).



Financial history never repeats itself exactly, but it always rhymes. So while those losses aren’t predictions, they are guidelines. You need to be “both willing and able to bear the loss,” says Mr. Salem. “Willingness is behavioral, ability is financial, and you can’t know for sure in advance which one is going to trump the other.”

So the best indication of whether you can take such a big hit is what you did the last time something similar happened. If, in 2008 and 2009, you bought more of any asset that fell in price, you are the rare investor whose intentions and actions may match. If you did nothing, you at least didn’t turn temporary losses into permanent ones by selling out at the bottom. If, however, you did bail out, then don’t fool yourself into thinking you won’t do it again. None of this means you shouldn’t own stocks—or any other asset. It just means you have to think more honestly about what you are getting yourself in for.

*Excerpt from an article written by Jason Zweig of the Wall Street Journal on 11-23-13*

### **Sugar High: 2014 Outlook ‘Credit Cassandras’ say Strong Demand for Risky Bonds is a Sign of Frothy Markets**

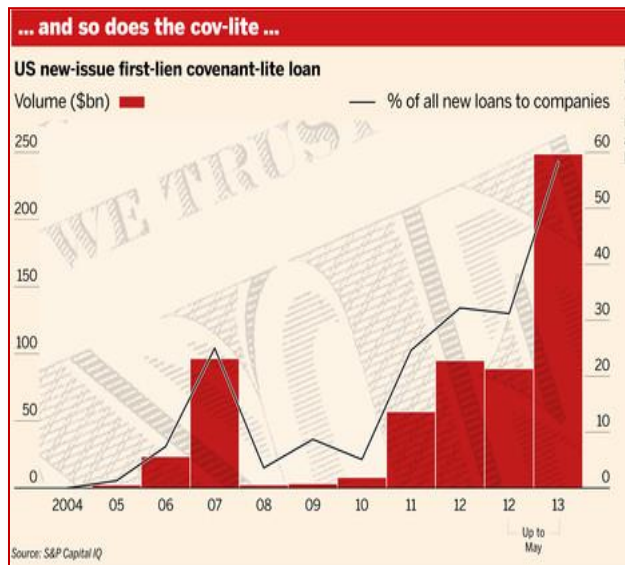
As snow fell in New York City on a December afternoon, waiters bearing trays of cookies fanned out among the group of bankers and investors gathered at the New York Athletic Club. The sweet biscuits were courtesy of Leonard Tannenbaum, chief executive of Fifth Street Management, who had a message for those attending the financial conference.

“I believe there’s another cycle coming,” said Mr Tannenbaum, whose specialist lending firm enjoys the support of investor David Einhorn. “So have the cookie. I want you to enjoy the sugar high – while it lasts.”

US credit markets rebounded in 2013 as a flood of central bank money and continued low interest rates pushed investors into riskier but higher-yielding assets. While many see the resurgent demand for

riskier loans and bonds as a natural effect of a nascent US recovery, others – such as Mr Tannenbaum – see it as evidence of a bubble blown by central banks. To the sceptics, the market is experiencing the kind of frothiness seen before the 2008 financial crisis. This, too, will end in tears, they warn.

Perhaps the foremost of these “credit Cassandras” is Jeremy Stein, the US Federal Reserve governor who warned in February that markets may be overheating. “A prolonged period of low interest rates, of the sort we are experiencing today, can create incentives for agents to take on greater duration or credit risks, or to employ additional financial leverage, in an effort to ‘reach for yield’,” he said, flicking through slides of warning signals. Since then, those warning signals have flashed ever brighter.



Issuance of syndicated leveraged loans – those made to companies that already carry high debt loads – reached \$535.2bn in 2013. That is just shy of the \$604.2 billion sold in 2007, at the height of the last credit bubble. Meanwhile, loans that come with fewer protections for lenders, known as “covenant-lite,” accounted for almost 60 percent of loans sold in 2013, compared with a 25 percent share in 2007. Sales of “payment-in-kind” notes, which give borrowers an option to repay lenders with more debt reached \$11.5bn in 2012 – a post-crisis high.

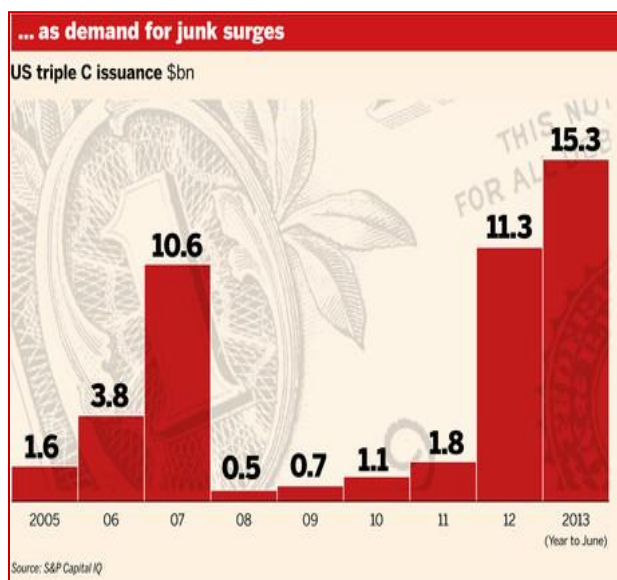
“There are no bargains in fixed income. We have seen a return to a lot of the practices that made people nervous in 2007 such as PIKs and cov-lite,” says Russ

Koesterich, chief investment strategist at BlackRock. Sales of “junk”, or high-yield, bonds surged to a record in 2013 as companies rushed to refinance and investors snapped up the resulting assets. Issuance of junk bonds rated “triple C” – the lowest designation – jumped to \$15.3bn, surpassing the pre-crisis peak...

Others cite reasons for optimism. They note that credit “spreads”, or the additional returns investors demand to hold riskier credit assets, are not yet near the historic lows experienced in the run-up to the 2008 crisis. That suggests investors are differentiating between riskier assets and relatively safe securities, such as US government debt.

In contrast to 2007, the current average junk bond yield of 5.6 percent is far higher than the yield on offer from the five-year Treasury note, at a difference of about 423 basis points. In June 2007, this spread had narrowed to a record low of 238 bps.

The argument against a bubble forming in the market at the moment is that overall credit remains abundant, enabling companies to roll over their funding, notes Mr Koesterich. “Companies can still raise money, so there is no financing risk.”



But investors who are concerned about the warning signs simmering in the credit markets may not be able to avoid investing in risky asset classes. For many, the pressure of reaching their “bogeys” – the benchmarks used to evaluate returns – is enough to justify the acquisition of riskier credit assets, particularly given the lack of yield on safer investments.

*Excerpt of an article that appeared in the Financial Times by Tracy Alloway and Michael Mackenzie on January 2, 2014*

### **Shadow Banking Default Threat as Chinese Coal Tycoon Goes From Black Into the Red**

A Chinese mining boss who threw a multimillion-dollar wedding for his daughter last year is now struggling under a pile of debts that threaten to trigger a major default in the country’s shadow banking industry.

Until a few weeks ago Xing Libin was known as the wealthiest man in Liulin, a county in northern China that struck it rich over the past decade thanks to bulging coal deposits. Looking more like a tousel professor than a slick tycoon, Mr Xing acquired mining rights for what local media said was “the price of a cabbage” and built his unlisted company, Liansheng Resources Group, into a big player in the Chinese coal industry.

Mr Xing put his success on display in March 2012 at a Rmb70m (\$11m) party to jointly celebrate his daughter’s wedding and his company’s 10th anniversary. He rented three aircraft to fly family and friends to the resort island of Hainan, brought in pop stars for a gala concert and assembled a fleet of six Ferraris for the wedding procession.

But since then the slowing Chinese economy and plunging price of coal have dealt a heavy blow to Liansheng and other mining companies across the country’s coal belt. On November 29, the Liulin County People’s Court in Shanxi province announced it had received an application from Liansheng to restructure its operations because it was unable to pay off loans...

Chinese regulators have long worried about debt risks in the coal industry and have in effect barred banks from lending cash to miners. Yet like its peers, Liansheng had little trouble finding willing lenders among China’s burgeoning shadow banks, which regulators have allowed to help plug the financing gap.

From late 2011 to early 2012, Jilin Trust, one of China’s vast array of non-bank financial institutions, sold to investors an investment product worth Rmb1bn backed entirely by loans to Liansheng. Jilin Trust warned investors at the start of this month that the first tranche of the Liansheng loans was nearing maturity and that the mining company had yet to cover what is owed, according to China Business News, a local financial newspaper...

Trust companies in China are often very demanding in their requirements for physical assets as collateral, but the Liansheng product was backed only by third-party guarantees. Jason Bedford, a former big four auditor who has focused on the Chinese trust sector for the past six years, said he had never seen a product that relied exclusively on third-party guarantees.



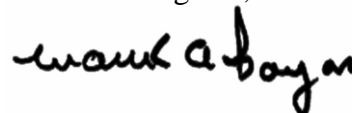
“This is clearly very risky,” he said. “If this was fully disclosed in the product prospectus and there is no evidence of mis-selling, then the loss could be passed on to investors.” Liansheng’s troubles are a reminder of the thin dividing line between China’s banks and its shadow lending industry. The Liansheng loan product sold by Jilin Trust was distributed in part via China Construction Bank, the country’s second-biggest lender by assets.

Banks tell customers they do not guarantee trust products, which offer returns far higher than traditional bank deposits, but buyers often ignore the warnings in the belief they carry the banks’ implicit backing. The Liansheng investment product targeted an annual return of 9.8 percent.

*Excerpt from the Financial times written by Simon Rabinovitch on 12-18-13*

If you have any questions or comments, please do not hesitate to call.

Best Regards,

A handwritten signature in black ink that reads "Mark A. Boyar". The signature is written in a cursive, slightly slanted style.

Mark A. Boyar