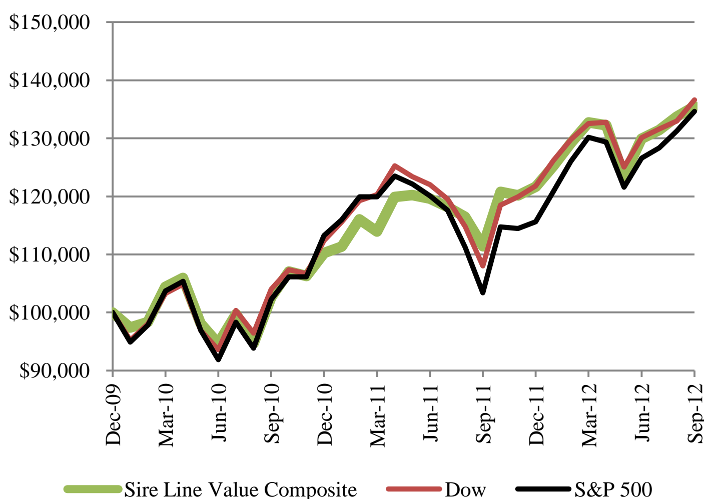
159 Madison Avenue, Suite 10i, New York, NY 10016 | (646) 526-8403 | info@sirelinecapital.com | www.sirelinecapital.com

October 20, 2012

Performance Report from
Daren Taylor, Portfolio Manager

THE VALUE OF A $100,000 INVESTMENT IN THE SIRE LINE VALUE COMPOSITE FROM INCEPTION (1/4/2010) TO PRESENT (6/30/2012) AS COMPARED TO THE S&P 500 INDEX AND THE DOW JONES INDUSTRIAL AVERAGE (UNAUDITED)



NOTE: Accounts included in this product composite are fully discretionary taxable and tax-exempt portfolios. They are managed under our value style, which invests primarily in high-quality businesses that 1) are simple to understand, 2) have a consistent operating history and favorable long-term prospects, 3) are managed by honest and able managers whose interests are aligned with ours and 4) can be purchased at a significant discount to intrinsic value. The performance of the Sire Line Value Composite is net of fees. All performance figures in the chart above begin as of the close on January 4, 2010.

Performance Measurement

The objective for all of our portfolios is to outperform all relevant benchmarks over the long term. The chart above shows a comparison of a $100,000 investment in the S&P 500 Index (S&P 500), the Dow Jones Industrial Average (Dow) and the Sire Line Value Composite since inception.

The S&P 500 is an unmanaged, market capitalization weighted index that measures the equity performance of 500 leading companies in the U.S. today. Firms included in the S&P 500 account for approximately 75% of the value of all U.S. stocks. Therefore, it acts as a fairly good proxy for the total market. Clients could easily replicate the performance of the S&P 500 by investing in an index fund at little cost. For discussion purposes below, I will focus on this benchmark to address our relative performance.

Third Quarter Performance

The Sire Line Value Composite (SLVC) increased in value by 4.3% in the third quarter, while the S&P 500 Index returned 6.4%. Year to date, the SLVC is up 11.4% vs. a gain of 16.4% for the S&P 500. And finally, since inception (1/4/2010) the SLVC has increased 35.5%, while the S&P 500 has gained 34.7%.

The following table summarizes the historical performance of the S&P 500, the Dow and the Sire Line Value Composite (SLVC) since inception:

	TOTAL RETURN (1)		
Annual	S&P 500 (2)	Dow (3)	**SLVC (4)**
2010	13.2%	12.4%	**10.3%**
2011	2.1%	8.4%	**10.3%**
2012 YTD	16.4%	12.2%	**11.4%**
Cumulative:			
2010	13.2%	12.4%	**10.3%**
2010-2011	15.6%	21.8%	**21.5%**
2010-2012 YTD	34.7%	36.7%	**35.5%**
Annual Compounded Rate:	11.4%	12.0%	**11.7%**

(Footnotes to table above)

(1) All performance figures begin as of the close on January 4, 2010.

(2) Based on changes in the value of the S&P 500 plus dividends (reinvested) that would have been received through ownership of the Index during the period.

(3) Based on changes in the value of the Dow Jones Industrial Average plus dividends (reinvested) that would have been received through ownership of the Index during the period.

(4) Based on changes in the value of the Sire Line Value Composite including dividends and after all fees and expenses.

The U.S., as well as most other developed countries, continues to struggle with high and growing levels of debt, which is mostly being driven by chronic fiscal budget deficits. Governments really only have three primary tools that they can use to help repair a "broken" budget: 1) tax rate increases (increases government revenue), 2) spending cuts and 3) fiscal policies that support and ignite economic growth. The first two actually have a negative impact on the third one, which means increasing tax rates and making large cuts to government spending really doesn't move a government closer to fixing its budget problems. Only by focusing on the third tool in the toolbox—implement policies that support and ignite economic growth—will a government move closer to fixing a budget crisis. Why? Higher economic growth requires additional investment, which drives higher demand for goods and services, which leads to more job creation, more people paying taxes, and higher tax revenues for government coffers. It also means

less people collecting unemployment benefits and other government distributions, which lowers government expenses. By focusing primarily on supporting economic growth, governments can actually increase the amount of revenue they bring in (without raising tax rates) and lower their expenses, which will help to fix their budget problems.

Unfortunately, here in the U.S. our elected officials have backed themselves into a "Fiscal Cliff" of mandated tax rate increases and government spending cuts, which are set to kick in at the beginning of 2013. Meanwhile, very little is being done by the current administration to implement policies to spur economic growth. Said another way, our elected officials in Washington are doing the exact opposite of what they should be doing to lower our debt and fix the current budget crisis.

On the positive side, the price of oil has softened, the housing market is showing signs of improvement and equity valuations for large corporations are not rich, especially after adjusting for the significant levels of cash and cash equivalents on corporate balance sheets.

Winners and Losers

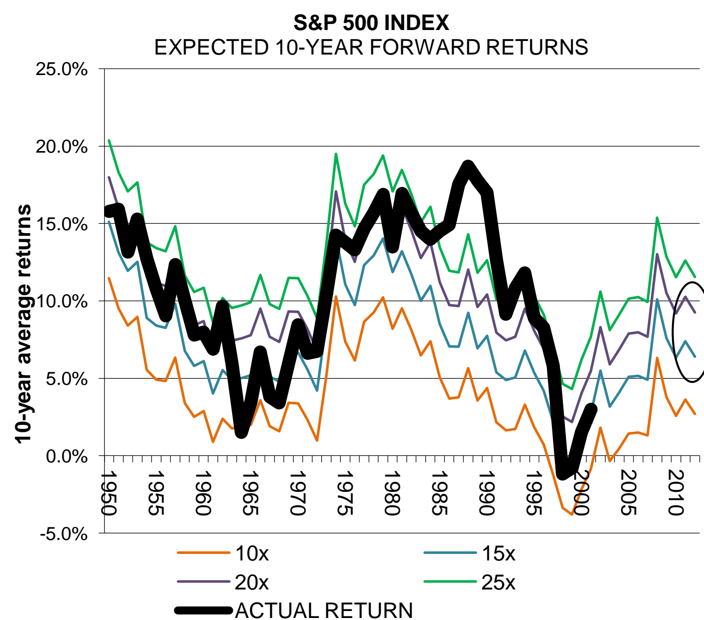
Our best performers in the quarter were Google (+30%), Walgreen (+23%), Time Warner (+18%), eBay (+15%) and Apple (+14%), while our worst performing stocks were Dell (-21%), Best Buy (-18%) and Intel (-15%).

I discussed the attractiveness of Dell in the last quarterly letter. The continued decline in the stock has dragged the company's market value down close to what I estimate to be Dell's replacement value. As a result I have added to our position. Best Buy continues to face stiff competition from online retailers. It is also suffering from a lack of new and exciting consumer electronics products, which help to drive more traffic into its stores. Despite these issues the company still produces some of the most attractive profit metrics in all of retail (i.e., sales and earnings per square foot, etc.) and generates a significant amount of free cash flow. That said, Best Buy is currently a small portfolio holding and I have been reluctant to add to it. And finally, Intel lowered its near-term earnings guidance during the quarter on weaker than expected demand in the marketplace. While the current environment is proving to be a challenge for this high-quality company (as well as other tech names), Intel continues to execute well, has a strong balance sheet and carries a 4.2% dividend yield. We have been adding to our position in Intel.

U.S. Equity Markets: Cheap or Expensive?

While we are stock pickers first and foremost, we recognize that it is also important to keep an eye on the overall value of equity markets. One measurement that we believe is a good indicator of whether U.S. equity markets are cheap or expensive is the expected 10-year forward rate of return on the equity market vs. the yield on the 10-year Treasury bond (the risk-free rate). Forward rates of return for the stock market can be implied by using its current valuation as a starting point, a conservative assumption for earnings growth going forward and a range of price-to-earnings (P/E) multiples in the final year. A 10-year time period is used to make sure that the model captures an entire economic cycle.

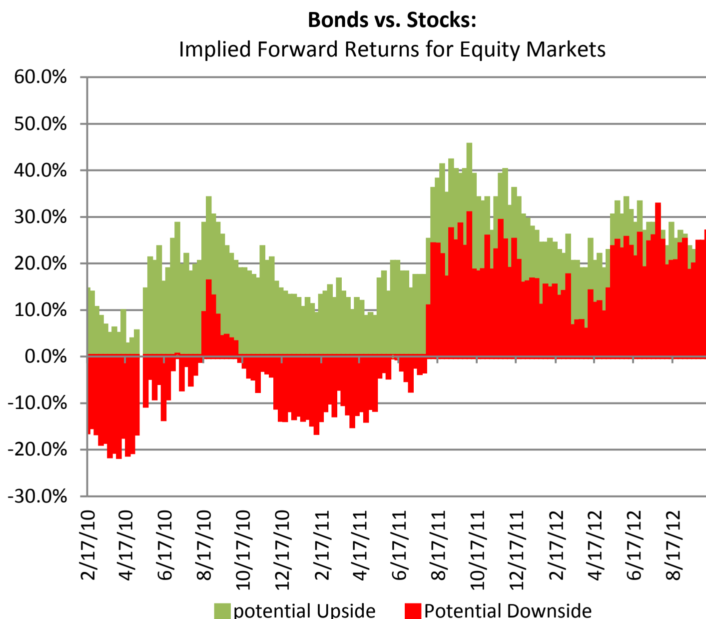
In the following chart, the thin colored lines represent expected 10-year forward rates of return for the S&P 500 Index assuming an average annual earnings growth rate of 5% and a range of ending price-to-earnings (P/E) multiples (between 10x and 25x). The heavy black line shows the actual 10-year forward rate of return for the S&P 500. Based on this analysis, the 10-year forward rate of return for the S&P 500 Index is expected to be in the range of 6.5%-9.5%, assuming an ending P/E multiple of between 15x and 20x (circled on far right of the graph).



Even if one were to assume a worst case scenario (an ending P/E multiple of only 10x), the expected rate of return for the market would still be higher than the current yield on the 10-year Treasury bond (2.7% for the S&P 500 vs. only 1.6% for the 10-year Treasury bond).

Another measurement that we track closely is the relationship between the yield on U.S. investment grade corporate bonds and the earnings yield for the equity market. The reason that this relationship is important is because bonds and stocks are always in competition for investor dollars. Investors will always gravitate toward the asset class that offers a higher risk-adjusted return.

Based on the historical relationship between these two yields, the current relationship implies that the risks in the equity market continue to favor the upside (potential upside of 22%). You can see this better in the chart below. (Simplistically, positive green/red means stocks are relatively more attractive than bonds, while negative red/green means stocks are less attractive than bonds.)



Equity markets in general do not appear to be richly valued, especially when measured against bonds. Most importantly, our investment portfolios are full of high-quality, undervalued businesses, which we are more than comfortable owning at this time.

Our Portfolio's Expected Rate of Return

As I write this report, the weighted average expected forward rate of return on our portfolios (based on free cash flow yield) is in the mid-teens. This compares favorably to our calculation of the forward rate of return for the S&P 500 Index of roughly 6.5%-9.5%, as well as the current 1.6% yield on the risk-free 10-year Treasury bond.

As always, thank you for your continued loyalty and support.

With appreciation,

Daren Taylor, CFA
dtaylor@sirelinecapital.com

Disclaimer: All information in this report is provided for informational purposes only and should not be deemed as an offer to sell or the solicitation of an offer to buy. References to specific securities and issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities. Past performance is no guarantee of future results. The opinions expressed herein are those of Sire Line Capital and are subject to change without notice. Entities including, but not limited to, Sire Line Capital, directors and employees may have a position in the securities mentioned above and/or related securities. This presentation is not intended for public use or distribution. Reproduction without written permission is prohibited.