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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 (3/31/2013) AS COMPARED TO THE S&P 500 INDEX (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 primary objective for all of our portfolios is to achieve the maximum long-term after-tax return on capital that is obtainable with minimum risk of permanent loss. The chart above shows a comparison of a $100,000 investment in the Sire Line Value Composite and the S&P 500 Index (S&P 500) 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.

First Quarter Performance

The Sire Line Value Composite (SLVC) experienced a gain of 9.5% in the first quarter, which was less than the robust gain of 10.6% for the S&P 500. As I have discussed with you before, you should expect our portfolios to perform in-line with, or slightly trail, the S&P 500 during boom periods for the general stock market. No matter which investment strategy an investor chooses, it is virtually impossible to outperform the market in both good years and bad. Bill Miller is known for having outperformed the S&P 500 for 15 consecutive calendar years—from 1991 through 2005—while managing the Legg Mason Capital Management Value Trust mutual fund. But that is it! Out of thousands and thousands of professional money managers over many decades, very few have been recognized for consistently outperforming the stock market in both good years and bad. I should mention that after outperforming for 15 consecutive years, Bill Miller significantly underperformed the S&P 500 in 5 of the next 6 calendar years—from 2006 through 2011. So much for consistency. I don't mean to belittle what Mr. Miller was able to accomplish from 1991-2005, but even he admitted that some of it was "...an accident of the calendar."

If one's goal is to maximize investment returns over the long term, it is important to focus first on downside protection because negative returns have a significant gravity-like effect on compounding. I believe it was Abraham Lincoln who once said, "I walk slowly, but I never walk backward." This pretty much describes our investment philosophy. Simply put, we are willing to give up some of the upside performance during boom periods for the general stock market in exchange for downside protection in bust periods.

Since inception (1/4/2010) the SLVC has increased 47.4%, while the S&P 500 Index has gained 48.4%. While the SLVC overall performance is slightly lower than the S&P 500, we have achieved our results with less volatility than the market. In addition, all of the figures above include reinvested dividends and are net of all fees and expenses. It should be noted that our private investment fund for high-net-worth individuals (Nearco Value Fund), which carries fund-specific operating expenses, accounts for over half of the SLVC. Excluding the impact of the relatively high operating expenses during the Fund's startup phase, the SLVC is comfortably outperforming both the S&P 500 since inception.

Out of the twenty-five total positions held in our portfolio during the most recent quarter, we owned sixteen stocks that increased by over 10%, five stocks that increased by over 20%, three stocks that increased by over 40% and one stock that increased by over 90%.

Best Buy was by far the best performing stock in the quarter gaining over 94%. The company's results in the quarter were better than feared, while the stock's valuation had reached an absurdly low level. Dell, which announced a management-led buyout offer of $13.65 per share for all of the outstanding shares of the company, was the next best performer gaining 41% in the quarter. In my last quarterly report to you, I wrote:

> *"The market continues to focus its attention on Dell's declining, low-value hardware business (PC manufacturing) rather than its improving, high-value enterprise solutions and services business. Investors are also overlooking the significant amount of cash and investments on the company's balance sheet, which amount to over $8 per share—roughly 80% of Dell's stock price at the end of 2012. We continue to have a sizable position in Dell."*

Apparently the person who knows the company better than anybody—Michael Dell—agreed with us as he and his private equity partners have offered to take the company private at a 35% premium to where the stock closed at the end of 2012. About a month after the announcement of the deal the company received not one, but two competing buyout offers at higher prices, neither of which meet my estimate of intrinsic value for Dell. It will be interesting to see how this plays out. More to come...

Walgreen's stock increased 29% in the quarter driven by an improved retail operating performance and news that the company is buying an equity stake in U.S. drug wholesaler AmerisourceBergen. The new wholesale partnership will provide many benefits to Walgreens, the most important of which will be to help the company better control expenses in what is expected to be a more challenging health care environment going forward.

My sentimental favorite stock in the quarter was definitely H.J. Heinz. The company's stock price increased 26% in the quarter on news that Warren Buffett and private equity firm 3G Capital have agreed to buy the entire company for $72.50 per share—$24 billion in total equity. When I launched Sire Line capital Management in January of 2010, Heinz was one of the first stocks that I purchased for our portfolios. It had all of the qualities that I look for in a great business and it was available at what I considered to be an attractive price. Thanks to Buffett's generous offer our clients recognized an 82% total return on their original investment in Heinz in only three years, which equates to a 22% average annual return over that time.

Only two stocks lost value during the quarter: Apple (-17%) and Coach (-10%). Competition for smartphones has increased and investors are worried that Apple will be forced to lower the price of its iconic iPhone, which would have a negative impact on the company's profitability. Coach, too, is experiencing stronger competition in its core product categories. Both names are likely to suffer a bit longer as the competition seems to be on a roll right now. However, their market valuations reflect what I consider to be a dire scenario for both firms. Apple and Coach are both high-quality businesses with strong global brands and pristine balance sheets. They are managed by able and honest management teams and they both generate substantial free cash flow. I am happy to relieve other investors of their shares in these fine businesses at such attractive prices.

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

	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	16.0%	10.2%	**10.7%**
2013 YTD	10.6%	11.9%	**9.5%**
Cumulative:			
2010	13.2%	12.4%	**10.3%**
2010-2011	15.6%	21.8%	**21.7%**
2010-2012	34.1%	34.3%	**32.7%**
2010-2013 YTD	48.4%	50.3%	**47.4%**
Annual Compounded Rate:	12.9%	13.4%	**12.7%**

(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.*

U.S. Equity Markets: Cheap or Expensive?

When investing in the stock market, every investor faces two primary risks: company-specific risk and market risk. Company-specific risk, which is the risk inherent in a particular company or industry, can be diversified away within a portfolio. Market risk on the other hand, which relates to the risk of collapse of an entire system or market, cannot be diversified away. I would characterize market risk as being high at the present time.

The U.S. and most other developed countries continue to struggle with high and increasing government debt, high unemployment, and low economic activity. Nearly every central bank in the world is printing money at a rapid pace in an effort to spark inflation and extinguish deflation. Why is deflation so bad? Deflation is basically a decrease in the general price level of goods and services. Why would anyone buy a car or house today if they knew they can get it cheaper in the future. The decision to defer purchasing into the future would result in a downward spiral in economic activity, which, among other things, would result in fewer jobs and lower wages for those lucky enough to keep their jobs. The U.S. went through this in the 1930s and Japan has been fighting deflation for the past twenty years.

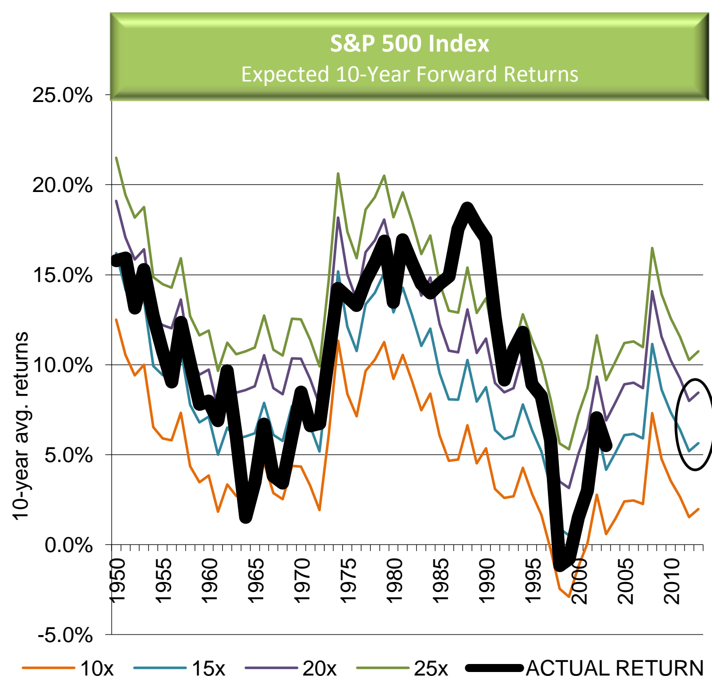
On top of this global deflation scare, there is renewed risk of a nuclear event happening thanks to the thunderous chest-beating coming from North Korea. Given that the country's new leader has not yet turned thirty years old, there is probably not much hair on that chest. Still, the equity market hates uncertainty, especially when it involves a hostile man-child with a million-man army and a thermonuclear weapon.

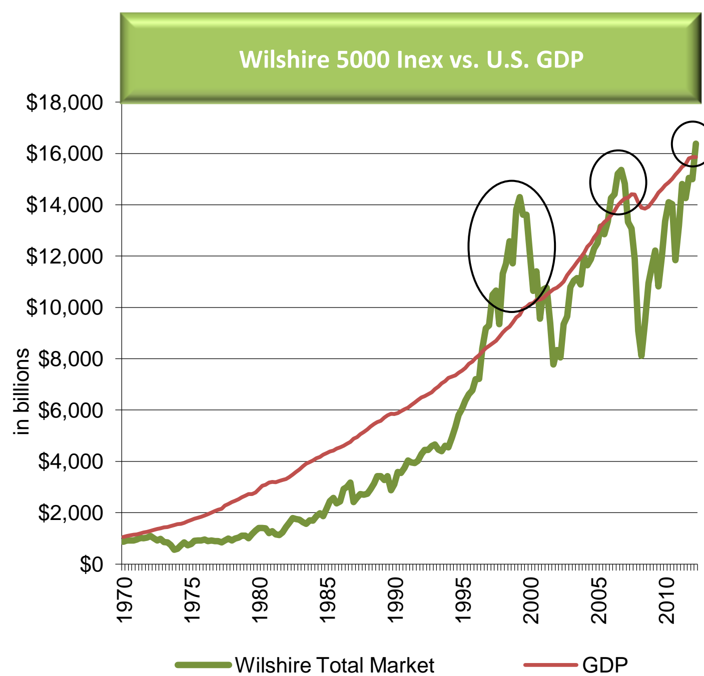
As for equity valuations, the S&P 500 has increased by 40% over the last year and a half. After experiencing such robust gains in such a short period of time, it is natural to think that the stock market may have gotten ahead of itself. I can't tell you how many people have recently mentioned to me that they are worried the stock market is overvalued. When I ask why they think that, they mention the strong stock market performance and the current headlines trumpeting new all-time highs reached for the Dow and the S&P 500. However, these reasons only address the headline market value of the stock market, not its underlying fundamental value. The price you pay for anything, including a stock, should always be compared to that which you receive in return. Benjamin Franklin had it right when he said, "The habit of relating what is being paid to what is being offered is an invaluable trait in investing."

Rather than thinking the stock market has never been higher and therefore must be overvalued, an investor is better served by trying to figure out what he or she is getting in return by investing in the stock market at current levels. The most common valuation measurement used for the stock market is the price-to-earnings ratio (P/E ratio). This measurement reflects how much an investor is paying (the "P") for each $1 of earnings received (the "E"). The current P/E for the S&P 500 is 14.3x, meaning that if you invest in the S&P 500 Index today you are paying $14.30 for each $1 of earnings received (although most of that $1 of earnings is usually reinvested back into the business for your benefit). Many investment professionals will argue that the long-term average P/E for the market is closer to 16x-17x and conclude that you are paying less today than the historical average for $1 worth of S&P 500 earnings. Therefore the current equity market, they would say, is actually <u>under</u>valued. Other investment professionals prefer to use a different version of the P/E ratio called the Shiller Cyclically Adjusted P/E ratio, which uses an inflation-adjusted 10-year average for the earnings number in the denominator (the "E"), rather than current year earnings, to account for cyclicality. On this basis, the S&P 500 is trading much higher at 23x, which is well above its long-term average of 16.5x.

Another measurement that I follow closely is the expected 10-year forward rate of return for the stock market. Forward rates of return for the stock market can be implied by using 1) its current valuation as a starting point, 2) a conservative assumption for earnings growth going forward, and 3) a range of 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 <u>expected</u> 10-year forward rates of return for the S&P 500 Index assuming a future earnings growth rate of 4% and a range of ending P/E multiples (10x, 15x, 20x and 25x), while the heavy black line shows the <u>actual</u> 10-year forward rate of return experienced for the S&P 500. Based on this analysis, the current 10-year forward rate of return for the S&P 500 Index is expected to be in the range of 5.5%–8.5% assuming an ending P/E multiple of between 15x and 20x (circled on far right of the graph).





Even if we were to assume the worst case scenario over the next 10 years—an ending P/E multiple of only 10x—the expected rate of return for the market would still be slightly higher than the current yield on the 10-year risk-free Treasury bond (1.9% for the S&P 500 vs. only 1.7% for the 10-year Treasury bond).

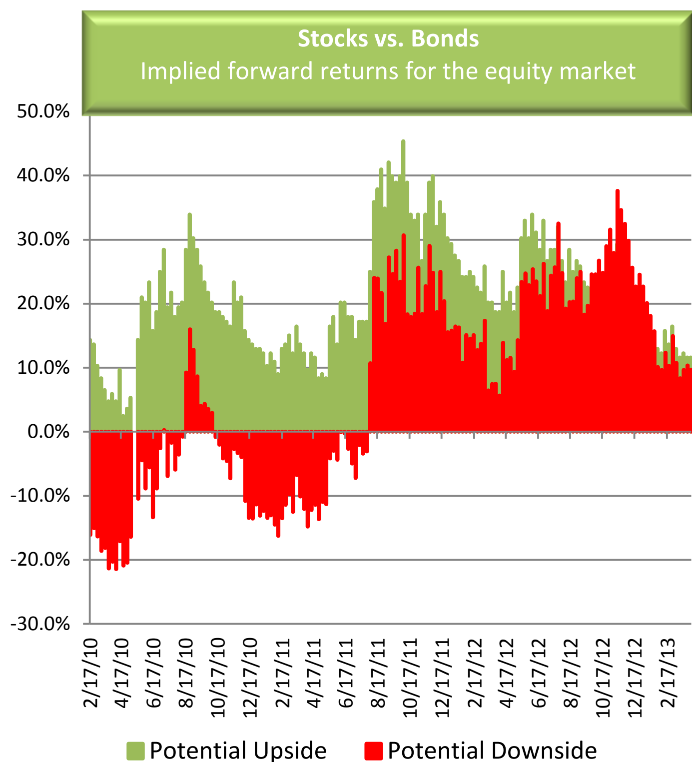
Given that the S&P 500 is a market-capitalization weighted index (larger companies are given more weight than smaller companies) and only represents about two-thirds of the overall U.S. stock market, by simply focusing on this index you may not be getting a complete and accurate view of the overall value of the U.S. equity market. That is why it is important to monitor other indices like the Wilshire 5000 Total Market Index, which measures the performance of all U.S. equity securities, and Value Line, which is an investment survey that tracks over 1,700 U.S. stocks.

One measurement that I believe is a good indicator of whether U.S. equity markets are cheap or expensive is the Wilshire 5000 Index relative to U.S. GDP. Think of this as the total equity market value of all U.S. stocks vs. the total value of all goods and services produced in the U.S.—or, the price-to-sales (P/S) ratio for the total stock market. With the Wilshire 5000 recently valued at $16.4 trillion and current GDP of roughly $15.9 trillion, the current ratio is around 103%. This is higher than the long-term average of around 73%. In addition, as you can see in the following chart there have only been two periods since 1970 when the Wilshire 5000 has traded at a higher value than U.S. GDP—once in the late-90s and again in 2007.

I probably don't need to remind you that the stock market fell by over 50% shortly after both of these periods. Now before we all start looking for a sale on mattresses (yes, to stash our cash!), let's see if other broad measurements are also flashing a distress signal.

Another measurement that I track closely is the relationship between the yield on U.S. investment grade corporate bonds and the earnings yield for the equity market (represented by the stocks in Value Line). 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 risks in the equity market continue to favor the upside (potential upside is 11%). You can see this better in the chart on the next page. (Simplistically, positive green/red means stocks are relatively more attractive than bonds, while negative red/green means stocks are less attractive than bonds.)



While there are some flashing warning signals, stocks in general continue to look relatively inexpensive when measured against bonds. In addition, the implied forward rate of return for the S&P 500 over the next ten years is only slightly lower than the long-term average. That said, I believe the biggest risk for the U.S. today is deflation and chronic high unemployment. As a result, I have lowered our equity exposure and increased our cash and short positions in all portfolios. The stocks that we continue to hold in our portfolios represent high-quality, high-value positions and I would be comfortable owning them in almost any environment.

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

With appreciation,

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