SIRE LINE
Capital Management

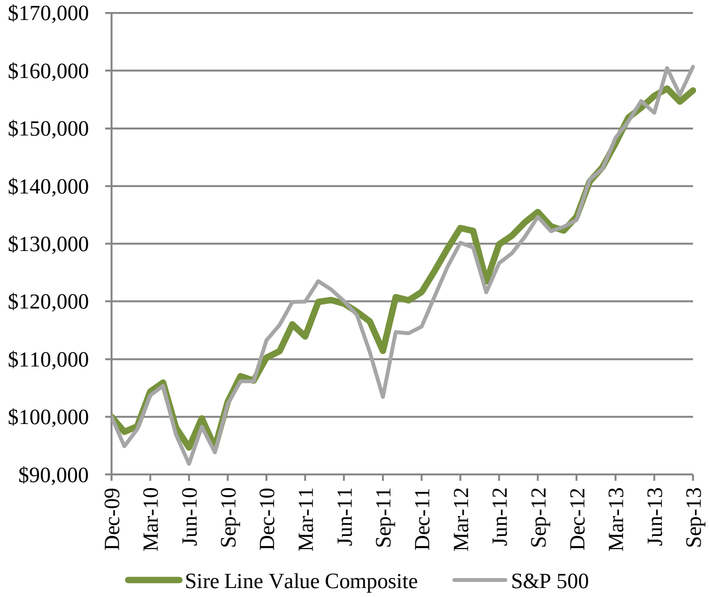
THIRD QUARTER 2013

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

November 5, 2013

Performance Report from
Daren Taylor, Portfolio Manager

Figure 1: THE VALUE OF A $100,000 INVESTMENT IN THE SIRE LINE VALUE COMPOSITE FROM INCEPTION (1/4/2010) TO PRESENT (9/30/2013) 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 total return on capital that is obtainable with minimum risk of permanent loss. The chart above (Figure 1) 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, I will focus on this benchmark to address our relative performance.

Our Performance

The Sire Line Value Composite (SLVC) experienced a gain of 0.6% in the third quarter, which was less than the 5.3% gain for the S&P 500. Year to date, the SLVC is up 16.3% vs. a 19.8% gain for the S&P 500. And finally, since inception, the SLVC has increased 56.6% vs. a 60.7% gain for the S&P 500. All of the figures above include reinvested dividends and begin as of the close on January 4, 2010.

After outperforming the S&P 500 in the first half of the year, our relative performance suffered in the third quarter as I became much more conservative with our portfolios throughout the period. Even though our long positions showed solid gains in the quarter, losses in our short positions offset much of the gains.

It is becoming more difficult to find attractive investment opportunities in the current environment. Equity market valuations in general have continued to increase while underlying economic fundamentals remain sluggish at best. Most investors are overlooking the fundamentals because they believe the Fed will continue to support high equity valuations for the foreseeable future by keeping interest rates at historical lows. This type of behavior reminds me of the childhood game of musical chairs in which participants laugh and have fun while the music is playing. However, once the music stops, there aren't enough chairs for everyone to sit down. For those left without a chair, the game is over. This is not a game I wish to play with our investment portfolios.

How long can the music keep playing before it stops? Nobody really knows. But experience has taught me that if the underlying economic fundamentals do not improve dramatically, either equity valuations in general must at some point pause to allow the fundamentals to catch up or equity valuations must fall to a level that better reflects the fundamentals. This presents the equity investor with the prospect of limited upside potential combined with sizable downside risk. As a result, during the most recent quarter I continued to increase our cash holdings and short positions. This more conservative profile for our portfolios will hurt our relative performance if equity valuations in general continue to move higher from here. However, being aware of the lopsided risks involved in the current environment, I am willing to sacrifice some upside in exchange for downside protection. In football parlance, you could say we are now playing a prevent defense. A prevent defensive alignment is one in which more defensive backs are used and placed further off of the line of scrimmage to prevent the opposing offense from completing a long pass for an easy touchdown. It is my opinion that at current valuations, the only way equity markets move considerably higher from here is by completing a Hail Mary pass. More on equity valuations in a moment...

The following table (Figure 2) summarizes the historical performance of the S&P 500, the Dow Jones Industrial Average (Dow) and the Sire Line Value Composite (SLVC):

Figure 2:	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	19.8%	17.6%	**16.3%**
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	60.7%	58.0%	**56.6%**
Annual Compounded Rate:	13.5%	13.0%	**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.

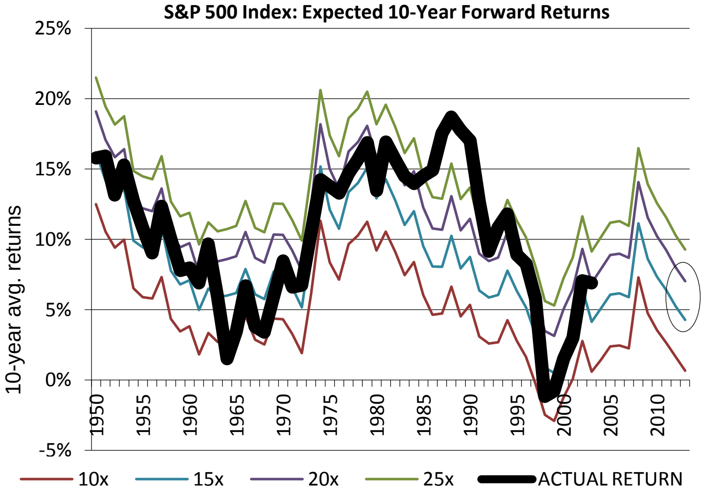
(3) Based on changes in the value of the Dow Jones Industrial Average plus dividends (reinvested) that would have been received through ownership of the Index during the period.

(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?

One measurement that I follow closely to gauge the current investment environment is the expected 10-year average forward rate of return for the S&P 500 Index. Average annual forward rates of return can be implied by using 1) current valuations as a starting point, 2) a conservative assumption of 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.

Figure 3:
S&P 500 Index: Expected 10-Year Forward Returns



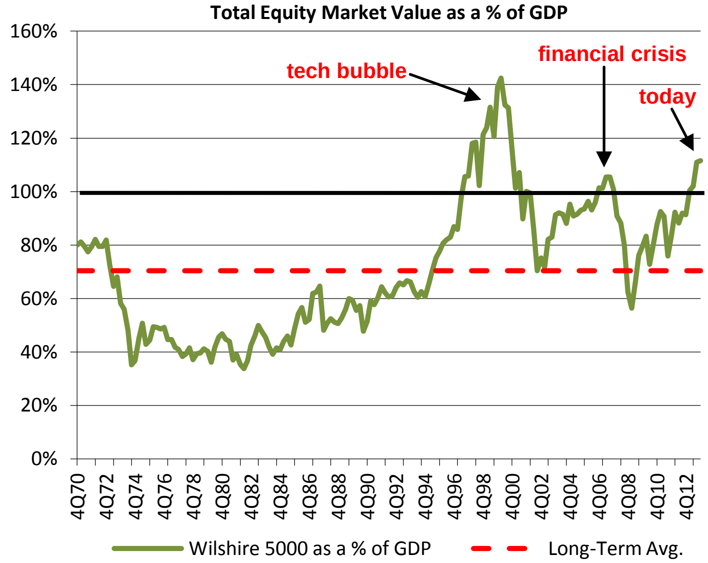
In the previous chart (Figure 3), the thin colored lines represent expected 10-year forward rates of return for the S&P 500 Index assuming future earnings grow at a 4% average annual rate (6% pre-2010) and a range of P/E multiples (10x, 15x, 20x and 25x) in the final year. The heavy black line shows the actual 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 4.3%–7.0%, assuming a final P/E multiple of between 15x and 20x (circled on far right of the chart).

While this does not sound like the end of the world for equity investors, it should be noted that since 1950, the only other period when the expected forward rate of return for the S&P 500 was this low was 1998—2003. Not a good time to be fully invested in the stock market. It should also be highlighted that in the worst case scenario (a P/E of 10x in the final year), investors in the S&P 500 Index would experience a 0% total return on their investment over the next 10 years.

Another measurement that I believe is a good indicator of whether U.S. equity markets are cheap or expensive is the value of the Wilshire 5000 Index relative to U.S. GDP (gross domestic product). 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. (the price-to-sales ratio for the total stock market, if you will).

With the Wilshire 5000 Index recently valued at $18.8 trillion and current GDP of roughly $16.8 trillion, the current ratio is around 112%. This is significantly higher than the long-term average of around 71%. In addition, as you can see in the following chart (Figure 4), there have only been two periods since 1970 when the Wilshire 5000 Index traded above 100% of U.S. GDP—once during the tech bubble of the late 1990s and again in 2007, just before the global financial crisis.

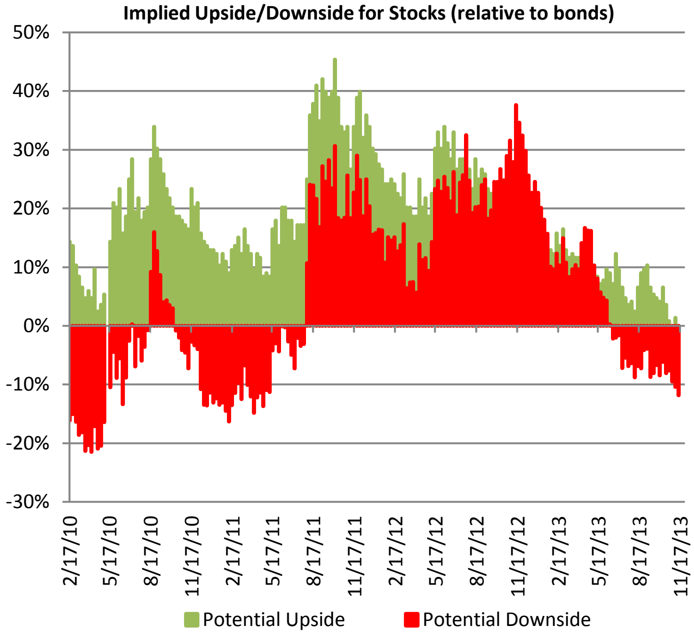
Figure 4:
Total Equity Market Value as a % of GDP



And finally, 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 the Value Line Investment Survey). 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 there is zero upside for stocks at current valuations. More specifically, the current relationship implies that there is -0.3% upside (a loss) and 12% downside risk for stocks given current valuations. You can see this better in the following chart (Figure 5).

Figure 5:
Implied Upside/Downside for Stocks (relative to bonds)



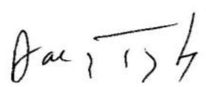
It is important to remember that the Fed is currently working very hard to force interest rates lower than they naturally would be, similar to that of a beachgoer holding an inflated beach ball below the surface of the water. If interest rates in general were to rise just one percentage point from current levels, the potential downside for stocks would be twice what is shown in the chart.

Given that all three of these broad valuation measurements are flashing a warning signal combined with the fact that I am not finding many bargains to invest in, our portfolios will remain conservatively positioned until conditions improve.

Let me reiterate again that the stocks we continue to hold in our portfolios represent high-quality, high-value investments. I would be comfortable owning them in almost any environment.

As always, thank you for your continued loyalty and trust. It is an honor for me to be able to help you protect and grow your hard-earned assets.

With appreciation,



Daren Taylor, CFA
dtaylor@sirelinecapital.com