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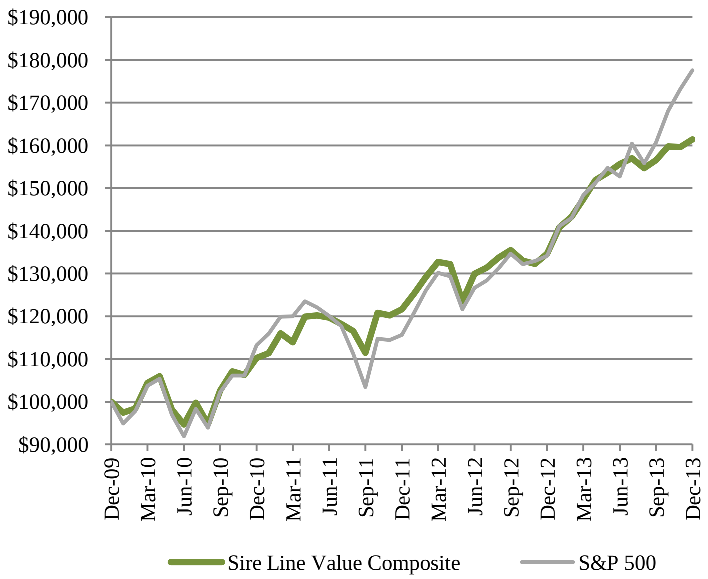
February 12, 2014

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 (12/31/2013) 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 all 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

For the full year, the Sire Line Value Composite (SLVC) increased in value by 19.9% vs. a gain of 32.4% for the S&P 500. Since inception, the SLVC has increased 61.4% vs. a 77.6% gain for the S&P 500. All of the figures above include reinvested dividends and begin as of the close on January 4, 2010.

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	32.4%	29.7%	**19.9%**
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	77.6%	74.1%	**61.4%**
Annual Compounded Rate:	15.4%	14.9%	**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.

Our investment portfolios had a strong first half of 2013, increasing by nearly 16%. This solid six-month performance outperformed the S&P 500 Index, which had increased nearly 14% over the same period. However, as equity prices and market risk in general continued to climb in the second half of the year, I increasingly became more conservative with our portfolios. My conservatism hurt our relative performance in the second half of the year as the S&P 500 was up 16.3% vs. our portfolios' measly return of just 3.7%. I expect this outperformance to reverse in the near future as equity prices in general will likely need to pull back to better reflect underlying economic fundamentals. It is simply not sustainable to have equity prices increase by over 30% a year while economic earnings are only growing at 5%. On a risk-adjusted basis, I am quite happy with our relative performance last year and believe our portfolios are positioned well for whatever lies ahead.

2014 kicked off with what I consider to be a high degree of market risk. Current equity valuations imply things are mostly back to normal for the U.S. economy. However, that is far from reality. While there is some good news to report—corporate balance sheets hold significant levels of cash, U.S. banking institutions are healthy again and the housing market has made a remarkable comeback—domestic economic growth remains subpar and the real underlying unemployment rate remains around 13% (vs. a "reported" unemployment rate of only 6.7%). The U.S. economy is in its sixth year of a recovery and the Federal Reserve has plowed through three expensive quantitative easing programs over that time in an effort to keep interest rates low and optimism high. In addition, our U.S. government is not financially sound. Our elected officials have a chronic spending problem, which has led to a significant debt problem for our country. The folks in Washington don't believe that we have a problem since they think they can just print money and everything will be okay.

The Federal Reserve has been buying much of the debt securities sold by the U.S. Treasury over the last few years. What does this mean? It means that the government is paying for its high rate of spending by selling IOUs to...ITSELF! (Is it just me or does anyone else think there is a problem with this?) Our total "reported" U.S. debt roughly amounts to $17 trillion, which is roughly equal to $55,000 per citizen. (Sounds like a pretty big number, right? Hold on, it gets better.) However, like the "reported" unemployment figure, this often-quoted U.S. debt figure masks our country's true, long-term economic obligations. For example, the assets of the Federal Reserve System are not consolidated into the federal government's balance sheet! If you were to include all of the future costs associated with the nation's social-insurance programs and other "off-balance sheet" items, our federal government's existing legal obligations are closer to $90 trillion (or $287,000 per citizen)! I hope I have your attention now. The U.S. government's financial reporting is extremely misleading and should never be taken at face value.

While I am troubled by this huge and growing debt problem, I am equally troubled by another significant risk that is not being broadly discussed by our elected officials (or even by investment professionals for that matter) and that is the risk of disinflation—or outright deflation—driven by our country's aging demographic profile.

Our nation is aging rapidly, which, generally speaking, means fewer productive workers adding value to our economy and more retired citizens extracting value from our economy. The result of this is slower economic growth, and possibly deflation. Japan has been living with this problem for the last twenty years (yikes!) and soon it will be our turn. Our inadequate leaders in Washington have spent the country's tax dollars recklessly and are not financially prepared to deal with this problem. And the icing on the cake is the fact that the Fed does not have many weapons left in its arsenal to continue to cover for this fiscal incompetence (i.e. interest rates can't go below 0%).

Given the significant amount of total obligations for the U.S. combined with its decelerating-growth demographic profile, the future does not appear to be as rosy as the equity market gains in 2013 seem to imply.

Top Holdings

Given the many risks in the market, why should we hold any stocks at all in our portfolios? Investment management is not about eliminating risk, it is about managing risk. A portfolio of all cash is not a successful long-term investment strategy. Over the last 100 years, the U.S. has experienced a Great Depression, a Great Recession, two world wars, the Korean War, the Vietnam War, two Gulf wars, a presidential assassination, a few market crashes and financial panics, as well as nearly twenty recessions. Yet despite all of this, the U.S. stock market has still managed to grow by roughly 10% per year on average. To paraphrase Buffett, investing is much more about purchasing, at a rational price, a small interest in an easily understandable business whose earnings are virtually certain to be higher five, ten and twenty years from now, despite what the economy does between now and then.

Fairfax Financial Holdings (FFH)

Think of FFH as a Berkshire Hathaway Mini-Me based in Canada. Back in the 1980s, investor Prem Watsa set out to clone Berkshire Hathaway. Since then, Prem has accumulated a strong stable of insurance businesses. In addition, FFH has a success rate over that time that closely resembles the success Warren Buffett has had managing Berkshire. Since 1986, FFH's book value per share has compounded at about a 23% rate, while the company's stock price has done equally as well (as one would expect). In addition to being a terrific allocator of capital, Prem is also a true risk manager and value investor. Aware of the broad market risks in today's investment environment, Prem has fully hedged his company's equity investment portfolio. And to add to the attractiveness of this investment for us, the company's stock is currently trading only slightly higher than book value (replacement value), which is understated in my opinion.

Microsoft (MSFT)

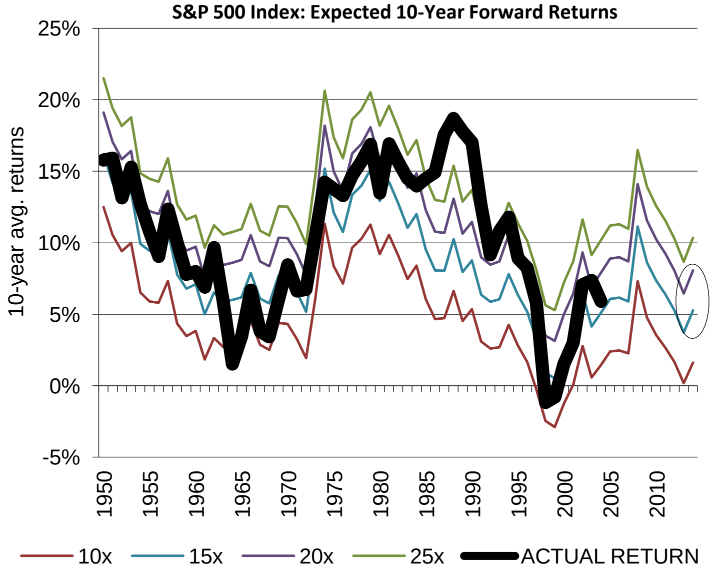
You will find a full stock analysis of MSFT on our website. I have had more than one person come up to me and say, "How can you invest in MSFT? The company's stock has done nothing over the last ten years." My reply is always the same: "That is exactly why I find the stock attractive today." The full explanation is that while the stock has done virtually nothing over the last ten years, operating earnings per share have more than tripled for the company over that time. And the next ten years for the company should be nearly as bright as the last ten years. As everyone correctly points out, MSFT's consumer products are struggling to keep up with competing products from the likes of Apple and Google. However, consumer only accounts for roughly 20% of MSFT's overall business. The commercial business, which makes up nearly 80% of total operating earnings, is still the company's crown jewel. The company is a cash machine and even has a higher credit rating than the U.S. government. At the current market price, MSFT's stock represents significant value for investors. We would have never invested in MSFT ten years ago, but we think it is a bargain today!

American International Group (AIG)
I spoke at length about our investment in AIG in the 2012 Annual Report. Please refer to that report for more details. AIG's businesses include global property & casualty insurance, domestic life insurance and domestic retirement services. AIG is an important player in the global insurance industry, having participated in it for nearly 100 years. The company is financially strong and is actually overcapitalized. Management is led by Robert Benmosche, a capable leader and industry veteran. The company is in the final stages of a turnaround following the 2008-2009 Financial Crisis in which the U.S. government was forced to inject over $180 billion of liquidity into the company to prevent an even bigger crisis. Today, the government is no longer an owner and most of the non-core assets have been sold off. What is left is a leaner, meaner, fighting machine with an overcapitalized balance sheet and a stock that is trading well below replacement value. More specifically, the stock is trading around $50 per share, well below its book value (replacement value), which is in the mid-$60s.

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

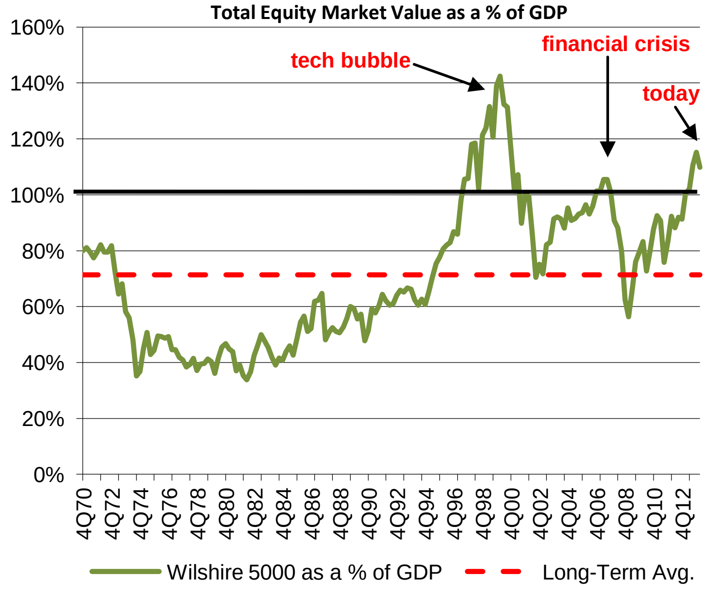


In the previous chart (Figure 3), the thin colored lines represent expected 10-year forward rates of return for the S&P 500 Index assuming future earnings grow at a 4% average annual rate (6% pre-2010) and a range of P/E multiples (10x, 15x, 20x and 25x) in the final year. The heavy black line shows 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 5%–8%, assuming a final P/E multiple of between 15x and 20x (circled on far right of the chart).

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 $18.7 trillion and current GDP of roughly $17 trillion, the current ratio is around 110%. This is significantly higher than the long-term average of around 71% (long-term median = 65.8%). 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

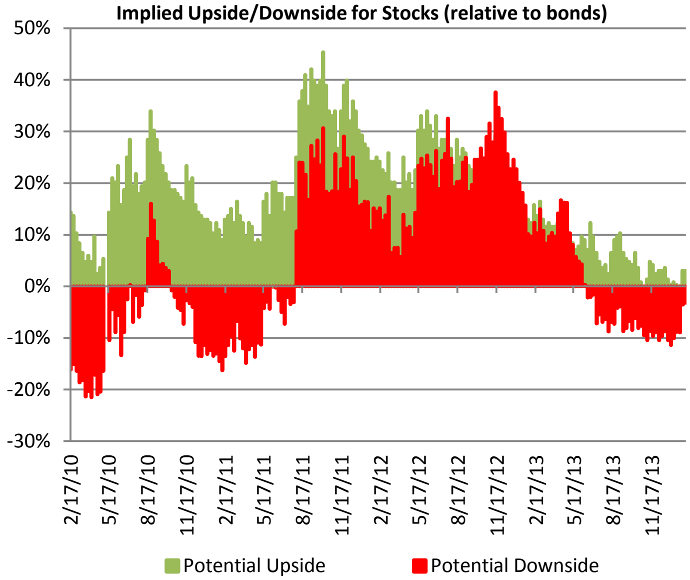


And finally, another measurement that I track closely is the relationship between the yield on U.S. investment grade corporate bonds and the earnings yield for the equity market (represented by the stocks in the Value Line Investment Survey). The reason that this relationship is important is because 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 little upside for stocks at current valuations. More specifically, the current relationship implies that there is only 3% upside for stocks relative to bonds given current valuations. You can see this better in the following chart (Figure 5).

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



Given that these and other broad valuation measurements continue to look overextended, combined with my concerns over slower future economic growth for our country (as well as much of the developed world), 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.

With appreciation,

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