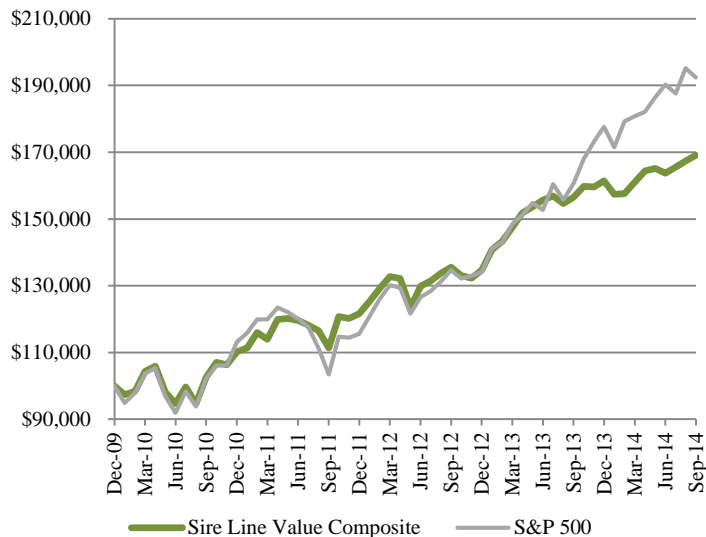


October 18, 2014

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 (9/30/2014) 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) increased by 3.3% in the third quarter vs. an increase of 1.1% for the S&P 500 (the Dow increased 1.9%). Year to date, the SLVC is up 4.8% vs. a gain of 8.3% for the S&P 500 (4.6% for the Dow). And finally, the SLVC has returned an average of 11.7% per year since its inception, while the S&P 500 returned an average of 14.8% (13.5% for the Dow) over that same period.

The quarter was a volatile one for global equity markets with both the S&P 500 and the Dow Jones Industrial Average experiencing losses in two of the three months. Even though both benchmarks managed to show an overall gain for the third quarter, the average U.S. stock mutual fund actually declined by 1.9% for the three-month period. The SLVC held up better than most showing gains of over 1.0% in each month during the quarter. Our outperformance was mostly driven by our large short position in small cap stocks. The Russell 2000 Index, which is the basis for nearly all of our short positions, showed a decline of 7.4% in the third quarter. As I have been preaching in these quarterly reports for the last twelve months or so, stocks in general remain highly priced and small cap stocks are the most highly priced asset class of them all. At recent highs, small cap stocks have been cheaper 98% of the time. Our significant short position in small cap stocks is not a “bet” that they will decline in value, but rather a type of “insurance policy” to protect our long positions against a broad market selloff. In addition, by having such a large short position I am not making a claim that I believe a significant market selloff is coming, rather that the risk of a significant market correction has increased substantially over the last year.

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)		
	S&P 500 (2)	Dow (3)	SLVC (4)
<u>Annual</u>			
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%
2014 YTD	8.3%	4.6%	4.8%
<u>Cumulative:</u>			
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%
2010-2014 YTD	92.4%	82.1%	69.1%
<u>Annual Compounded Rate:</u>	14.8%	13.5%	11.7%

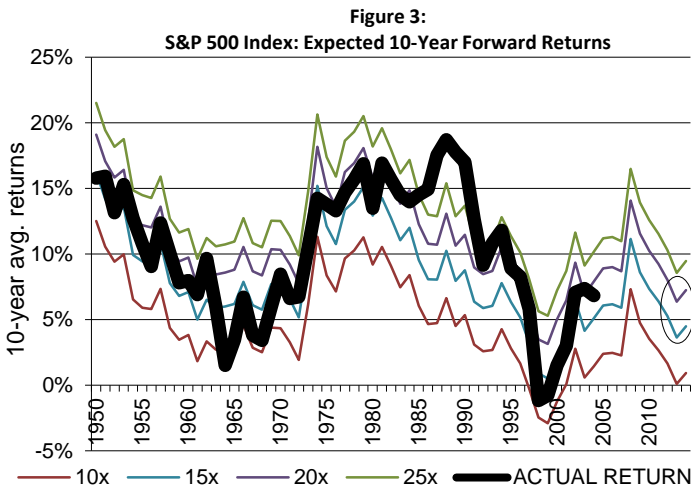
(Footnotes to table above)

(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.

U.S. Equity Markets: Cheap or Expensive?

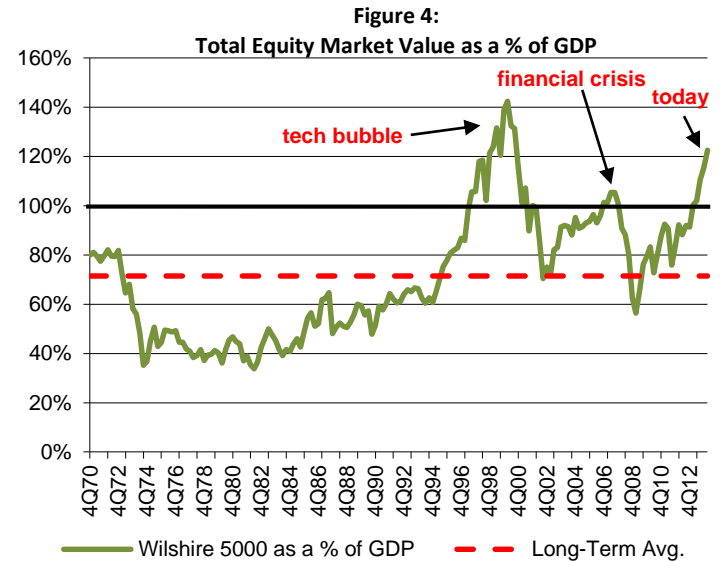
One measurement that I follow closely to gauge the current investment environment is the expected 10-year average forward rate of return for the S&P 500 Index. Average annual forward rates of return can be implied by using (1) current valuations as a starting point, (2) a conservative assumption of earnings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



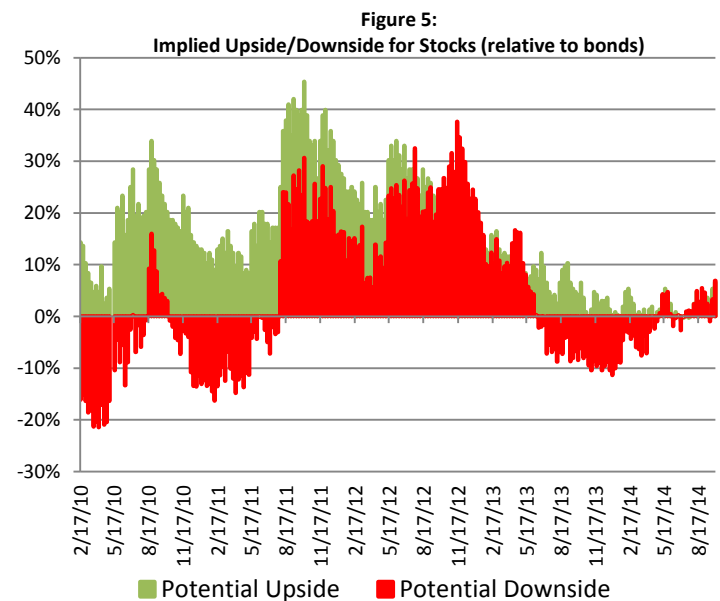
In Figure 3 above, the thin colored lines represent expected 10-year forward rates of return for the S&P 500 Index assuming future earnings grow at a 4% average annual rate (6% pre-2010) and a range of P/E multiples (10x, 15x, 20x and 25x) in the final year. The heavy black line shows the actual 10-year 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 4.0%–7.0%, assuming a final P/E multiple of between 15x and 20x (circled on far right of the chart). While these expected returns do not sound bad on the surface, they are actually the 2nd lowest projected returns that this model has produced since 1950. The lowest was during the tech bubble in the late 1990s.

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 over \$20 trillion and current GDP of roughly \$17 trillion, the current ratio is around 122%. 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 prior 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.



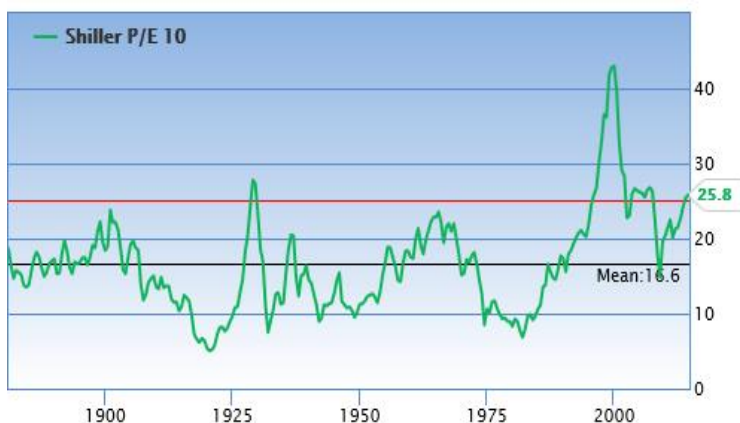
Another measurement that I track closely is the relationship between the yield on U.S. investment grade corporate bonds and the earnings yield for the equity market (represented by the stocks in the Value Line Investment Survey). The reason that this relationship is important is because bonds and stocks 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 6% upside for stocks in general at current valuations. You can see this better in the previous chart (Figure 5).

And finally, the most common valuation metric used by those investors that continue to believe that current equity valuations are attractive is the price-to-earnings (P/E) ratio for the S&P 500 Index using forward earnings. The argument goes that the current P/E ratio of less than 16x is roughly in-line with its historical average. Therefore, they say, stocks in general are not overvalued but “appropriately” valued. As most of you know, my value-based approach to investing was shaped very early on by the teachings of Benjamin Graham, the professor at Columbia Business School who wrote many great investment books and who would go on to teach many great investors, including Warren Buffett when he attended Graham’s investment class in the early 1950s. In his 1934 book (some might say financial bible) entitled Security Analysis, Ben Graham wrote, “The whole idea of basing the value upon current earnings seems inherently absurd, since we know that the current earnings are constantly changing.” He went on to say that, “A conservative valuation of a stock issue must bear a reasonable relation to the average earnings...which should cover a period of not less than five years, and preferably seven to ten years.”

**Figure 6:
CAPE Ratio**



Source: <http://www.gurufocus.com/shiller-PE.php>

Current Yale University professor Robert Shiller has taken this idea one step further and has come up with what is known as the cyclically-adjusted price-to-earnings ratio—or CAPE for short—which measures the price of the S&P 500 Index relative to its average of ten years of earnings, adjusted for inflation. The chart on the left (Figure 6) shows the history of this measurement going back over 100 years.

Based on this measurement, the current value of 25.8x has only been eclipsed in two prior periods looking back over the last 100 years: 1929 and 1997-2007.

Given that these and other broad valuation measurements that I follow continue to look overextended, combined with my inability to find suitable investments with attractive risk-adjusted forward rates of return, all of our client portfolios will remain conservatively positioned until conditions improve.

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,

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