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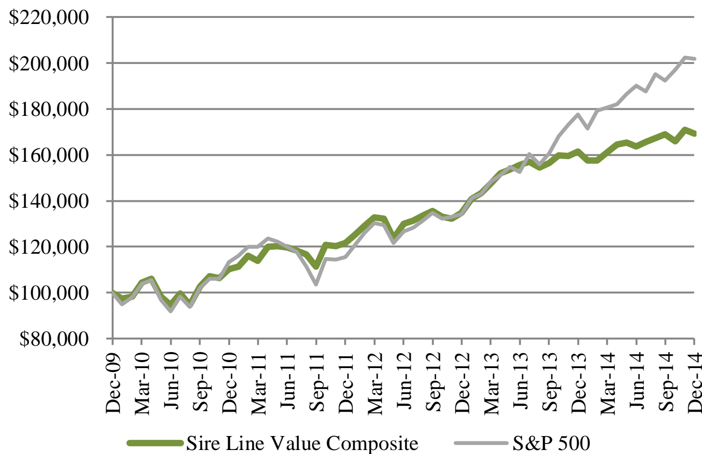
January 20, 2015

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 (12/31/2014) 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 0.2% in the fourth quarter vs. an increase of 4.9% for the S&P 500 (the Dow increased 5.2%). For the entire year, the SLVC increased 5.0% vs. a gain of 13.7% for the S&P 500 (10.0% for the Dow). And finally, the SLVC has returned an average of 11.1% per year since its inception, while the S&P 500 has returned an average of 15.1% (13.9% for the Dow) over that same period.

Our underperformance since the latter part of 2013 is entirely due to my being overly conservative given what I perceive to be heightened market risk. More on that 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	32.4%	29.7%	**19.9%**
2014	13.7%	10.0%	**5.0%**
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%**
2010-2014	101.9%	91.6%	**69.4%**
Annual Compounded Rate:	15.1%	13.9%	**11.1%**

(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 best performing stocks during the fourth quarter were Staples (+50%), Oracle Corp. (+17.5%), Fairfax Financial Holdings (+17.4%), Time Warner (+13.6%) and Twenty-First Century Fox (+12.0%). Our worst performers during the quarter were European-based companies: Credit Suisse Group (-9.3%) and Heineken (-5.0%). After being one of our best performing positions in the third quarter, our short holdings combined were down over 11% in the final quarter of 2014, which offset much of our strong performance in our long positions.

For the full year, thirteen stocks in our portfolio gained over 10%, with the best performers being Intel (+40%), Fairfax Financial Holdings (+31%), Berkshire Hathaway (+27%), Microsoft (+24%) and DirecTV (+23%). Our worst performing stocks were Weight Watchers (-38%), Coach (-38%) and Credit Suisse (-12%). In addition, our losses in our short positions were a significant drag

on our overall returns in 2014. I know it is difficult to watch the stock market continue its upward momentum while our portfolio lags behind because of our conservative positioning. However, when financial markets normalize, only those with significant liquidity will be in a position to take advantage of the fallout.

Being investors in the stock market, we face two primary risks: company-specific risk and market risk. Company-specific risk, which is non-systemic risk specific to a certain firm's operations and unique business environment, can mostly be diversified away by holding as few as 13—15 well-diversified stocks. Market risk on the other hand, which is the risk of a broad financial market decline as a result of a shocking global event or other macro factors, cannot be diversified away.

There are two ways that Sire Line Capital manages market risk. First, we only invest in high-quality businesses that we can purchase at a significant discount to intrinsic value. Buying a stock at a discount to the firm's underlying business value provides us and our clients with a margin of safety, limiting our downside if the market in general should decline. And the other way we manage market risk is by holding high cash reserves and shorting the most overvalued segment of the market when we perceive market risk to be high.

There are many signs in the current environment that point to a heightened level of market risk. Equity valuations in general (which I will talk more about later in this report) are at levels only experienced at prior market peaks (1902, 1929, 1966, 2007). The only prior period to reach a higher peak than what we are experiencing today was during the late 1990s at the height of the technology boom.

Current equity valuations are not reflecting a booming economy with high corporate investment, strong economic growth, above-average productivity gains and increasing real wages. Actually, none of these are occurring today despite being six years into this recovery. Relaxed monetary policy is the primary reason why equity valuations are currently so high. The bond market is a large competitor for the stock market and when interest rates are declining, stocks, as well as other assets, become relatively more attractive. The interest rate on long-term U.S. Treasury bonds recently touched an all-time historic low. The current low interest rate environment has forced investment dollars to flow into higher risk assets, such as stocks, and in the process have pushed valuations up to historical highs. If our economy's future was sunny and bright, market risk wouldn't be so high. However, I see many storm clouds building on the horizon.

The global economy is struggling with low growth. Almost every mature economy in the world is suffering from excessively high government debt, low growth, an aging population and disinflation. In addition, emerging markets, which had been the driver of global growth recently, have seen their growth slow as well. We are seeing this show up in the economic data, but it is also being reflected in commodity prices, many of which have fallen significantly over the last year. If you have been watching the news lately you already know that the price of oil has declined over 50% in just the last few months. While oversupply has been a factor in driving the price of oil down, demand has also pulled back. Other important commodities that have seen rapid and significant declines include iron-ore (-50%), cotton (-29%), copper (-21%) and silver (-20%).

As economic growth slows, countries lower their interest rates, which weaken their currencies, which in turn helps their exports, which should ultimately help employment. The problem is, almost every country in the world is doing this currently and the global pie is only so big.

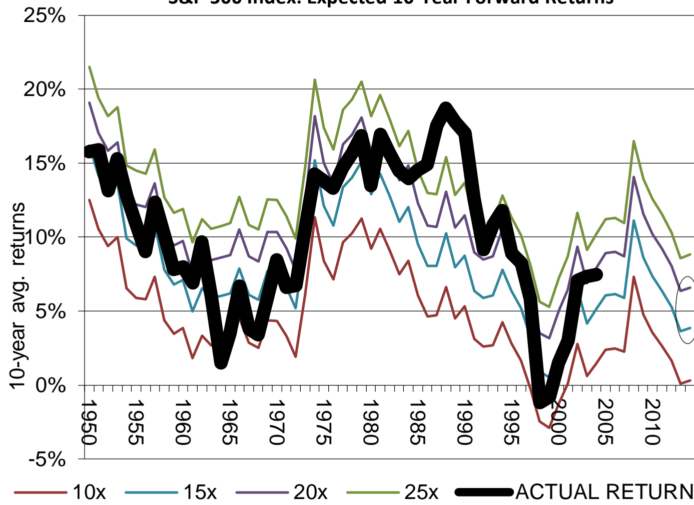
Prem Watsa, Chairman and CEO of one of our portfolio holdings, Fairfax Financial Holdings, is one of the best risk managers today. He considers the 2008-2009 contraction to be a one in 50 or a one in 100 year event—similar to the 1930s in the U.S. and Japan since 1990. Unprecedented monetary stimulus has prevented our economic system from purging all of the bad management practices and the misallocation of capital—both in the private and public sectors—in order to prepare the way for the next expansion.

Economic stimulus is not unlike the stimulus one receives from a drug addiction. Over time as the body becomes conditioned to a certain level of "medication," more medication is needed to have the same stimulating effect. As we are all aware, these situations never end well. What is eventually needed is treatment and recovery. The same is true for the U.S. economy. Rather than seek treatment to wean ourselves from this addiction, the Federal Reserve continues to be an enabler, feeding our addiction. Granted, the recovery process is usually very painful to go through. However, without it we will never be able to reach our full, long-term economic potential. Besides, the alternative can often lead to an overdose.

U.S. Equity Markets: Cheap or Expensive?

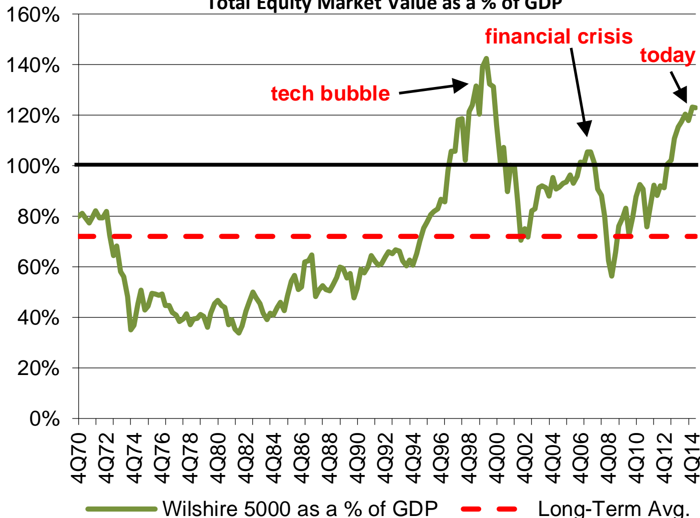
One measurement that I follow closely to gauge the current investment environment is the expected 10-year average forward rate of return for the S&P 500 Index. Average annual forward rates of return can be implied by using (1) current valuations as a starting point, (2) a conservative assumption of earnings 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 on the next page, the thin colored lines represent <u>expected</u> 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 <u>actual</u> 10-year forward rate of return experienced for the S&P 500.



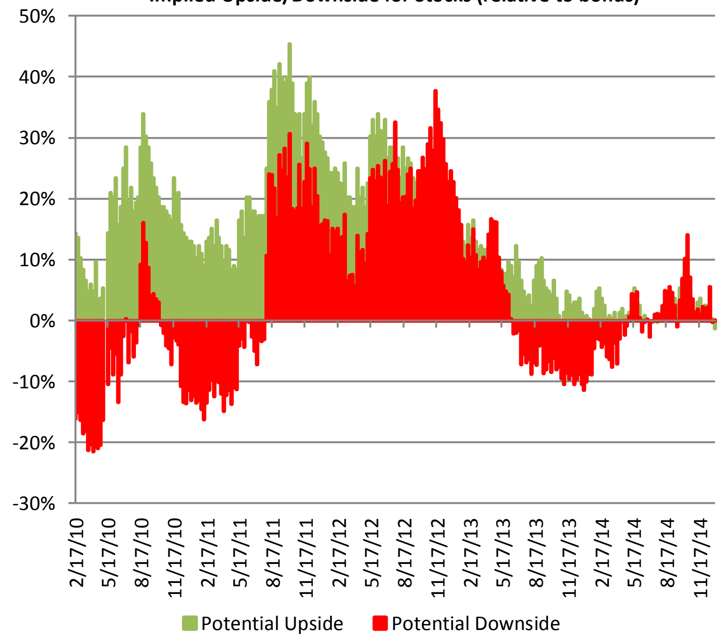
Based on this analysis, the current 10-year forward rate of return for the S&P 500 Index is expected to be in the range of 3.5%–6.5%, assuming a final P/E multiple of between 15x and 20x (circled on far right of the chart). While these expected returns do not sound all that bad, they are actually the second lowest projected returns that this model has produced since 1950. The lowest was during the tech bubble in the late 1990s. In addition, given that the dividend yield on the S&P is currently 2%, it implies a price return of just 1.5%-4.5% per year going forward.

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 valued at close to $22 trillion and current GDP of roughly $17.5 trillion, the current ratio is around 125%. This is significantly higher than the long-term average of around 71% (long-term median = 66%). In addition, as you can see in the prvious 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). As I mentioned earlier, 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.



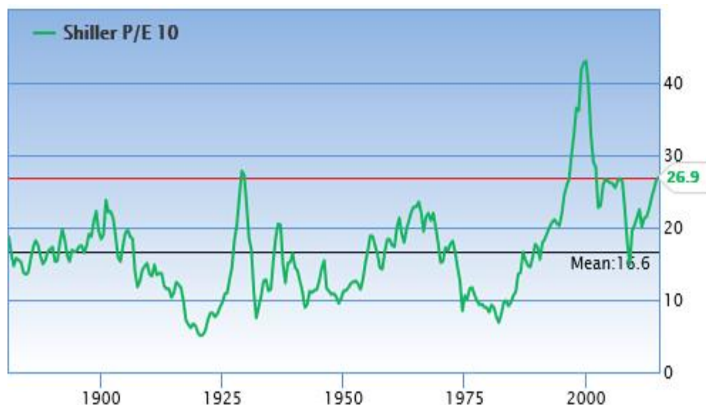
Based on the historical relationship between these two yields, the current relationship implies that there is 0% upside for stocks in general at current valuations. You can see this better in the chart above (Figure 5).

And finally, the most common valuation metric used by those investors that continue to believe 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 17.5x is only slightly higher than its historical average. Therefore, they say, stocks in general are not overvalued but "appropriately" valued. However, there are a couple of reasons why I take issue with this argument.

First of all, the S&P 500 Index is a market-cap-weighted index, meaning the largest companies in the index hold higher weight. Many of the largest names in the index currently are in the financials, energy and "old tech" sectors, all of which are currently trading at relatively low multiples. The median P/E ratio for the S&P 500 is currently above 20x, well above the cap-weighted P/E ratio. It is also interesting to note that at the peak of the tech bubble in 2000, the median stock traded at a 35% discount to the cap-weighted multiple.

The other big complaint I have with forward P/E multiples is that it is based on short-term earnings, which can be highly volatile and easily manipulated by managements. Yale University Professor Robert Shiller has taken Ben Graham's original idea that a company's stock should be valued against its average earnings over a long period of time, and has come up with what he calls 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 next chart (Figure 6) shows the history of this measurement going back over 100 years.

Figure 6:
CAPE Ratio



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

Based on this measurement, the current value of 26.9x has only been eclipsed in two prior periods looking back over the last hundred years—1929 and 1999 (see Figure 6). Its historical median is 16.6x, well below where it stands today.

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

Tax Documents

For those of you that have a taxable account with me, our custodian should have your Form 1099 finalized in late February. You will need to include this with your tax return. If you should have any questions or concerns, please feel free to contact me directly.

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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