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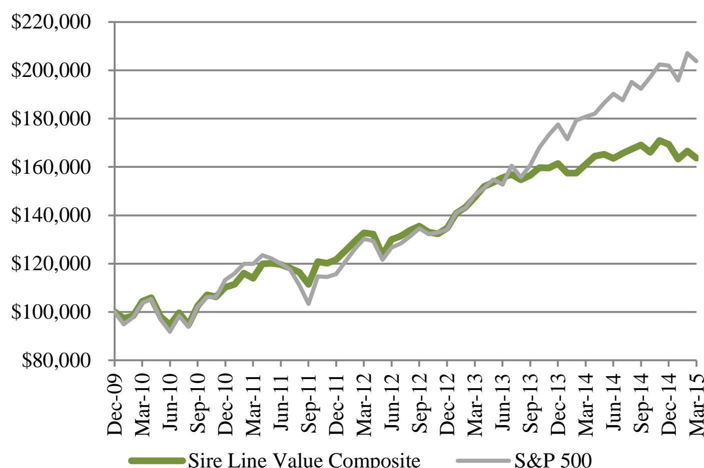
May 17, 2015

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 (3/31/2015) 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. Although all of Sire Line Capital's portfolios are managed for absolute performance, for discussion purposes below I will focus on this benchmark to address our relative performance.

Our Performance

The Sire Line Value Composite (SLVC) experienced a net decline of 3.35% over the three month period ending in March vs. a gain of 0.95% for the S&P 500 (0.33% for the Dow Jones Industrial Average). The decline in our portfolios during the most recent quarter was mostly driven by short-term issues with our two largest positions: Microsoft (MSFT) and our short holdings in equities. We have already seen one of these short-term issues (MSFT) reverse itself in the first few weeks of the second quarter, which helped our portfolio to gain over 3.2% in the month of April alone. (As I write this letter, we are nearly back to even on the year.)

The other short-term issue, which is related to our significant short position in equities, is also expected to reverse itself. This short position, which is inversely related to the stock market, has lost value as stocks have continued to get more expensive. It is important to understand that these losses are unrealized and are expected to reverse back to gains when broad valuations normalize. In fact, as equity valuations in general have continued to get richer, I have been adding to our short holdings in equities.

Our underperformance since the latter part of 2013 is entirely due to my being overly conservative given what I perceive to be a heightened level of market risk. Our short position in equities has been a drag on our overall performance since I initiated the position in the second half of 2013. However, as I explain further below, this protective position is needed at the current time.

Our Short Holdings in Equities:

The largest overall position in our portfolios is a short position on the Russell 2000 Index (small-cap stocks). Markets in general, and small-cap stocks in particular, are at or close to historically high valuations. What is important to know is that the high valuations are not supported by fundamentals. The primary reason for these high valuations is that central bankers around the world are flooding their markets with free, or virtually free, money. This cannot continue. And it won't.

As stock markets around the world have continued to climb higher, our short holdings, which are inversely related to the stock market, have declined in value. This decline combined with the decline in MSFT is mostly responsible for the overall decline in the first quarter. However, as our MSFT loss in Q1 was a temporary event, so too will be our loss in our hedges.

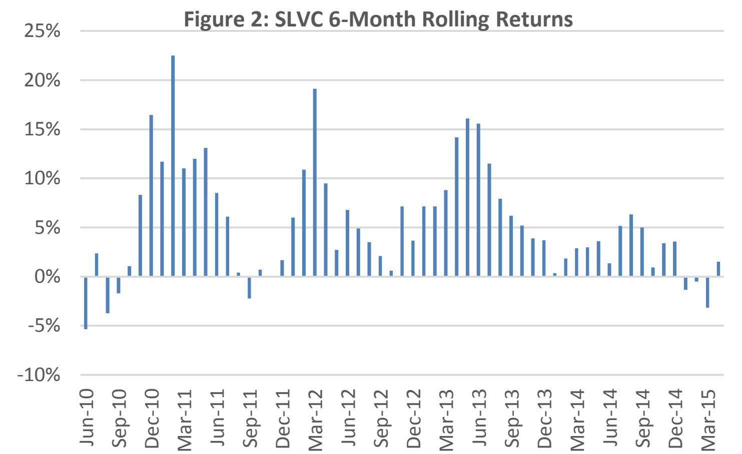
The purpose of our short position in equities is to protect our capital from a significant decline in the stock market, a decline that could be on the magnitude of 20%, 30% or even 40%. There has only been one other period in the last 100 years or so when stocks in general have been more expensive than they are today. Based on certain broad valuation metrics, only during the tech bubble in the late 1990s have stocks been more expensive than they are today. And if you were to make adjustments for current peak corporate profit margins and historically low interest rates, we are much closer to the valuations of the late 1990s than most people realize. How did that turn out for equity markets? The S&P 500 Index and the NASDAQ only just recently showed a gain from their year 2000 highs—some 15 years later. If you owned either of these benchmarks back in 2000 and did not hedge your position, your investment account has been underwater for the better part of the last 15 years!

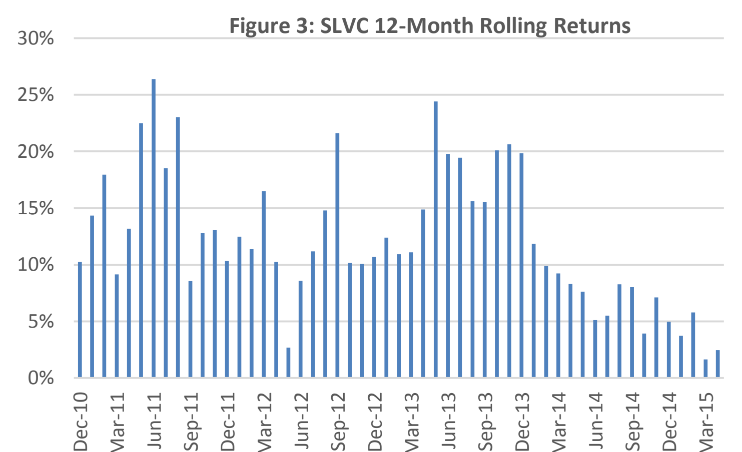
In hindsight, I was early in hedging our portfolio. But when protecting our valuable capital from this kind of significant risk, it is always better to be too early than too late. The way our portfolios are currently positioned, if the stock market were to fall 20%, 30%, or even 40% tomorrow, I would expect our portfolio to be flat-to-slightly up. Basically, we are completely hedged.

And just as a reminder, I have virtually my entire net worth and my family's net worth invested in the very same portfolios as my clients. So my money is right next to your money experiencing all of the same losses and gains as your money. Unfortunately, the short-term pain we are feeling today because of these unrealized declines in our protective hedges is necessary in order to protect and maximize our risk-adjusted returns over the long term. To quote Howard Marks, one of the best risk managers in the investing world today, "Whatever few awards are presented for risk control, they're never given out in good times." When describing superior portfolio risk control, Marks like to use the analogy of building a house near a fault line. "A good builder," he says, "is able to avoid construction flaws, while a poor builder incorporates construction flaws. When there are no earthquakes, you can't tell the difference."

The S&P 500 Index and the Dow Jones Industrial Average have not had a correction of 10% or more since 2011. That is the third-longest period without at least a 10% decline since 1929. (Thank you, central banks!) To come back to our earthquake analogy, just because you have not experienced an earthquake near a fault line in a long time does not mean that the risk of an earthquake occurring has declined. On the contrary. Little or no recent seismic activity near a fault line usually means that the pressure between tectonic plates is growing. This couldn't be a more apt analogy for the stock market today. Our portfolio hedges are necessary in the current environment and I am confident that we will be rewarded for remaining patient and disciplined.

One last thing that I want to mention, especially to those of you who are new to Sire Line Capital. Be careful when looking at our short-term performance, whether it be relative or absolute. I manage all of our portfolios for absolute performance, not relative performance. And because I usually focus our portfolios on a select number of our best investment ideas, the concentrated nature of our portfolio can sometimes result in higher volatility than the market, both on the upside and the downside. We experienced some of this in the first quarter. However, over longer periods of time our volatility profile looks extremely good. For example, the next two charts (Figure 2 & 3) show the net returns for our Sire Line Capital composite on a 6-month and 12-month rolling basis since inception:





As you can see in the first chart above, there have only been a handful of times since we have been in operation that our portfolios have experienced a decline in value over any 6-month period. And the second chart clearly shows that we have never experienced a decline over any 12-month period.

Microsoft

Microsoft, which was our largest stock holding for most of the first quarter, declined 14% during the period after reporting quarterly earnings in late January. Not only did I keep our position in Microsoft, I added to our holdings after the significant drop in price. Why?

Driven by its highly skilled new management team, Microsoft is in the process of changing its business model from a product-cycle-driven model to more of a subscription- and license-based, mobile- and cloud-centric model. This transition will make quarterly numbers look a little messy in the near term, but the new business model will eventually produce much more consistent and annuity-like earnings, which should eventually receive a higher valuation in the marketplace (investors prefer less volatile earnings streams). In addition, as this transition picks up momentum, I expect to see accelerating revenue growth.

Don't pay attention to the newspapers that say Apple and Google are killing Microsoft. Roughly 80% of the value of Microsoft comes from their commercial business, which Apple and Google hardly compete in. This is a wonderful business that produces high returns on invested capital and throws off a tremendous amount of free cash flow. And it is actually growing at an above-average rate. To top it off, the company's credit rating is higher than the U.S. government's rating, the dividend yield is nearly 3% and management has stated they will be spending at least $4 billion each quarter on share buybacks. Even with this significant amount of capital being returned to shareholders, the cash on the company's balance sheet is still expected to increase!

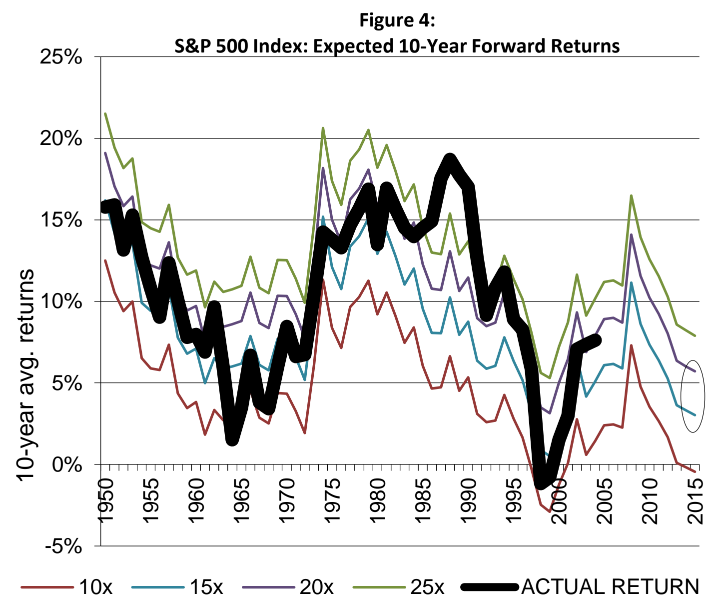
Virtually half of our portfolio's decline in the first quarter was because of the significant decline in the stock of Microsoft after they reported a messy quarter to end 2014. But we made back virtually that entire loss on one day in April after the company reported its quarterly earnings for the first calendar quarter (the stock was up 11% on that day).

Microsoft is a very cheap stock, even after its big gain in April. That is why it remains one of our largest holding. We have owned it in our portfolio since 2010 and the stock has basically doubled over that time. It equates to about a 15% average annual return. And after including all dividends received, our total return on this investment has been about 18% per year. Given its current valuation, the expected forward rate of return is still in the double-digits, which, after considering you can only make about 2% per year on a 10-year Treasury bond, is an extremely attractive risk-adjusted return today. On my company's website, you will find a presentation that I did on Microsoft back in 2012. The presentation shows how I arrive at my valuation for this great business. Let me know if you have trouble finding it.

U.S. Equity Markets: Cheap or Expensive?

One measurement that I follow closely to gauge the current investment environment and the overall level of risk in the stock market 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.

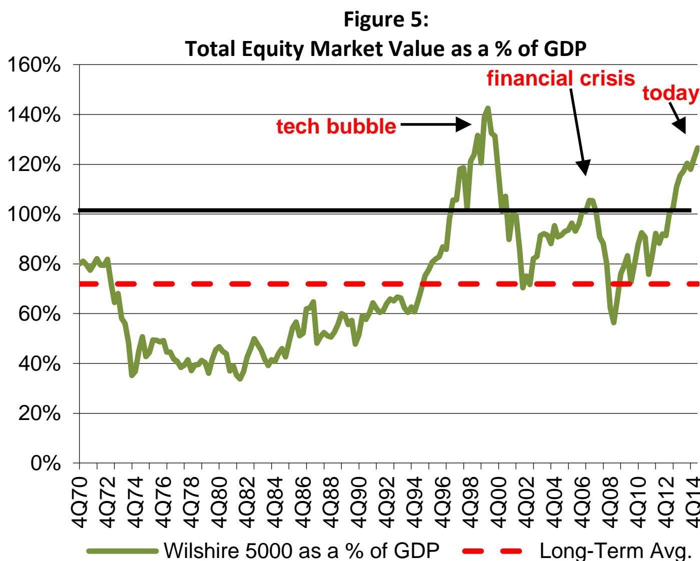
Figure 4:
S&P 500 Index: Expected 10-Year Forward Returns



In the chart above (Figure 4), 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

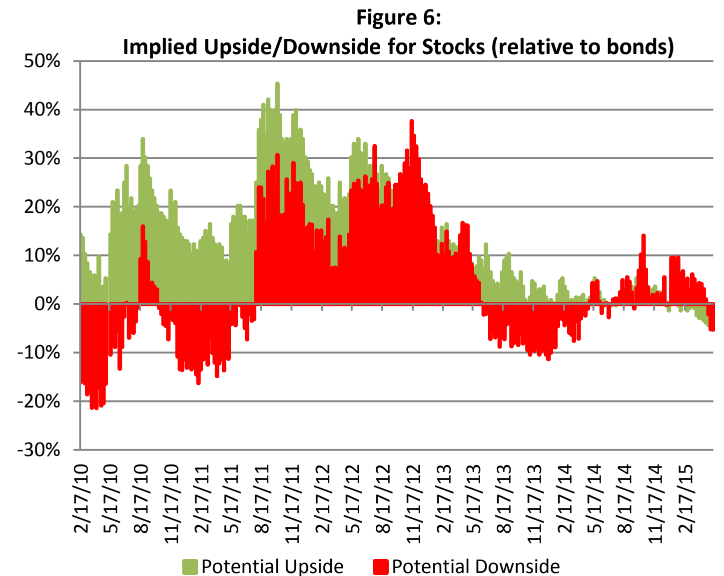
range of 3.0%–6.0%, assuming a final P/E multiple of between 15x and 20x (circled on far right of the chart). While these expected returns do not sound all that bad, they are actually the second lowest projected returns that this model has produced since 1950. The lowest was during the tech bubble in the late 1990s. In addition, given that the dividend yield on the S&P is currently 2%, it implies a price return of just 1.0%-4.0% 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 $22.5 trillion and current GDP of roughly $17.7 trillion, the current ratio is around 127%. This is significantly higher than the long-term average of around 71% (long-term median = 66%). In addition, as you can see in the previous chart (Figure 5), 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 negative returns for stocks in general. You can see this better in the previous chart (Figure 6).

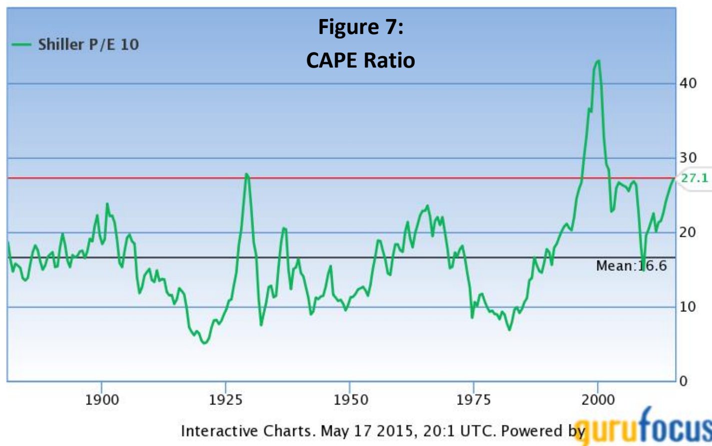
And finally, the most common valuation metric used by those investors that continue to believe current equity valuations are attractive is the price-to-earnings (P/E) ratio for the S&P 500 Index using forward earnings. The argument goes that the current P/E ratio of roughly 18.5x is only slightly higher 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 shows the history of this measurement going back over 100 years.

Based on this measurement, the current value of 27.1x has only been eclipsed in two prior periods looking back over the last hundred years—1929 and 1999 (see Figure 7). Its historical median is 16.6x, well below where it stands today.



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

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, all of our 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,

Daren Taylor, CFA
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