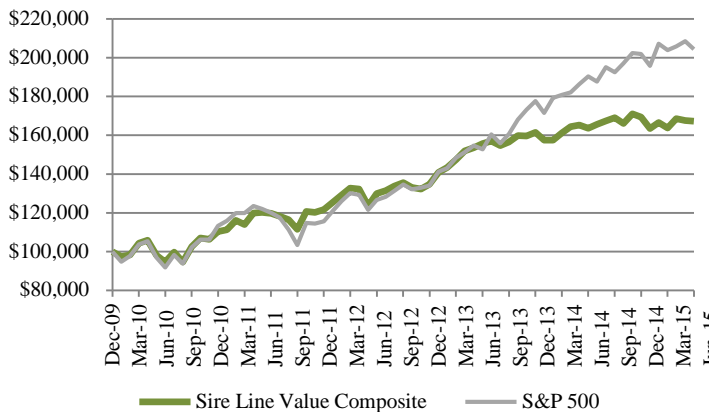


July 27, 2015

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 (6/30/2015) 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 gain of 2.2% over the three month period ending in June vs. a gain of 0.3% for the S&P 500 (a 0.3% loss for the Dow Jones Industrial Average). The favorable relative performance of our portfolio was driven by gains in a few of our largest holdings including AIG (+12.8%), Citigroup (+7.2%) and Microsoft (+8.6%). Our relative underperformance over the last eighteen months is mostly a result of the losses that we have experienced in our short positions (protective hedges) that I began to put into the portfolio in late 2013. I expect these losses, which are mostly unrealized, to reverse into gains once broad equity valuations normalize.

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: Annual	TOTAL RETURN (1)		
	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%
2015 YTD	1.2%	0.03%	-1.3%
<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	101.9%	91.6%	69.4%
2010-2015 YTD	104.4%	91.6%	67.3%
<u>Annual Compounded Rate:</u>	13.9%	12.6%	9.8%

(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.

AIG contributed the most to our performance in the quarter. Our initial investment in AIG was back in the fall of 2012 at a price below \$34 per share. At its current price of roughly \$64 and including dividends, we have experienced a gain of over 90% on our original investment in just three years—a roughly

30% average annual rate of return. Given that AIG is our largest holding today at nearly 10% of our investment portfolio, I wanted to give you a bit more color as to why it deserves to be such a significant holding for us.

Back during the financial crisis of 2008, AIG was at the epicenter of the derivatives tsunami that hit the shores of the financial sector. Faced with a devastating short-term liquidity crisis, the company desperately needed a bailout by the U.S. government. Since then, AIG, under the direction of a talented new management team, has sold off or shut down non-core businesses and assets and has paid back over and above what they received from the U.S. government in the bailout. AIG is no longer in the businesses that caused all the trouble as AIG has refocused on its core businesses of life and property & casualty insurance. It should be noted that these core businesses continued to perform admirably throughout the financial crisis and were never the cause of the company’s liquidity concerns.

Having been in the business for nearly 100 years, AIG has built an enviable reputation as a leader in the global insurance industry. While it is earning less today, a high-quality insurance franchise such as AIG’s should be able to generate normalized returns on equity capital of at least 10%. Which means that with a current equity book value per share of \$80, AIG’s normalized earnings power is close to \$8.00 per share (0.10 x \$80). Given AIG’s current stock price of around \$64, this implies a valuation of 0.8x book value (\$64 ÷ \$80) and 8x normalized earnings (\$64 ÷ \$8). High-quality insurance franchises are worth considerably more than this. However, we don’t need to wait for the stock market to pay us a higher multiple to realize a satisfactory risk-adjusted return on our investment going forward.

AIG should earn around \$6.00 per share this year on its way to earning a more normalized rate of \$8.00 sometime over the next five years. Assuming earnings don’t grow, however, and the company only earns the same \$6.00 each year over the next five years, AIG’s book value per share will increase from \$80 to \$110 (assuming no dividends or stock repurchases). At the same price-to-book value multiple as today’s 0.8x, AIG’s stock price would increase from \$64 to \$88. So assuming an extremely conservative scenario over the next five years (i.e. earnings don’t improve back to normalized levels and the stock continues to trade for less than replacement value), we would realize a 40% increase in our investment in AIG vs. a less than 12% return by investing in 10-year, risk-free Treasury bonds over the same period.

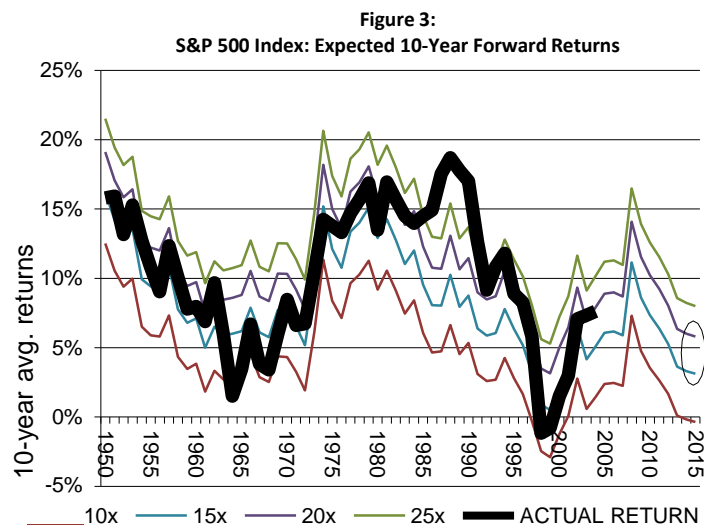
If on the other hand we get a normalization of valuations and return on capital for AIG, we could easily see another double in this investment from here. The asymmetrical risk profile of this investment is extremely attractive and difficult to find in the current marketplace. Therefore, it deserves to hold a prominent place in our portfolio.

During the quarter I initiated new positions in Diageo PLC and Gilead Sciences, and I eliminated five holdings—Heineken, Intel, Lab Corp. of America, Staples and Time Warner.

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 and dividends 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.

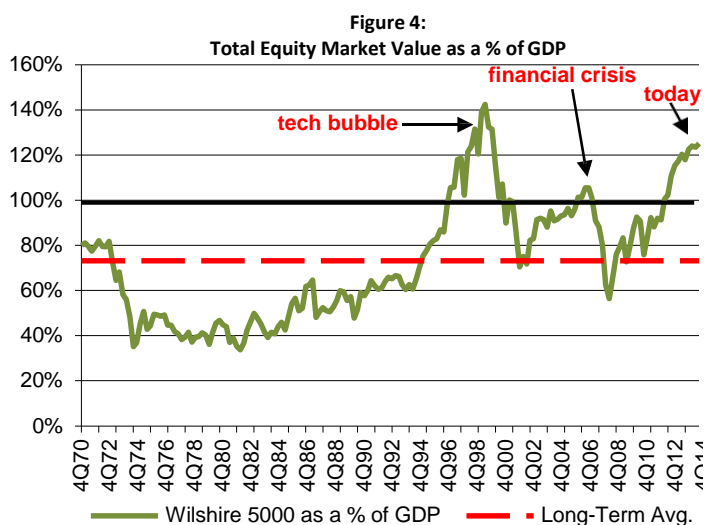
In Figure 3, the thin colored lines represent expected 10-year forward rates of return for the S&P 500 Index assuming future earnings grow at a 4% average annual rate (6% pre-2010) and a range of P/E multiples (10x, 15x, 20x and 25x) in the final year. The heavy black line shows the actual 10-year forward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

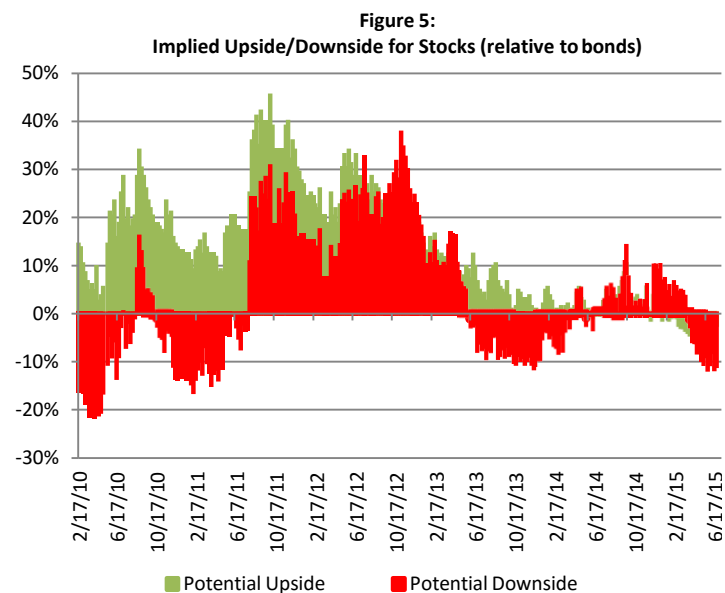


With the Wilshire 5000 Index valued at over \$22 trillion and current GDP of roughly \$17.7 trillion, the current ratio is around 125%. This is significantly higher than the long-term average of around 73% (long-term median = 67%). In addition, as you can see in the previous chart (Figure 4), there have 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 negative returns for

stocks in general. You can see this better in the next chart (Figure 5).



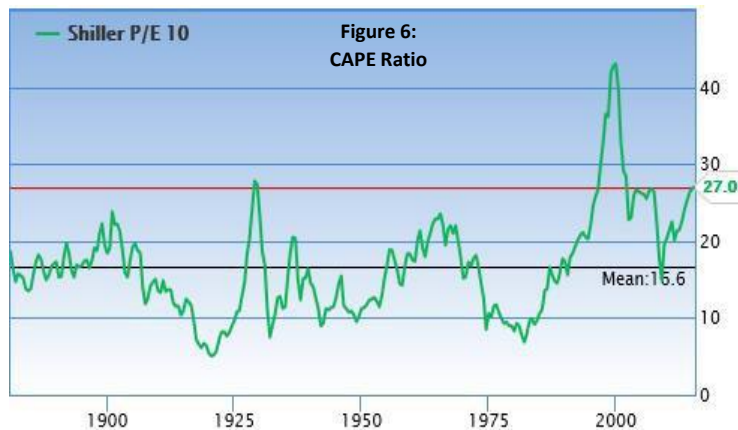
And finally, the most common valuation metric used by those investors that continue to believe current equity valuations are attractive is the price-to-earnings (P/E) ratio for the S&P 500 Index using forward earnings. The argument goes that the current P/E ratio of roughly 18.5x is only slightly higher 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 27x has only been eclipsed in two prior periods looking back over the last hundred years—1929 and 1999 (Figure 6).



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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