SIRE LINE Capital Management

THIRD QUARTER 2015

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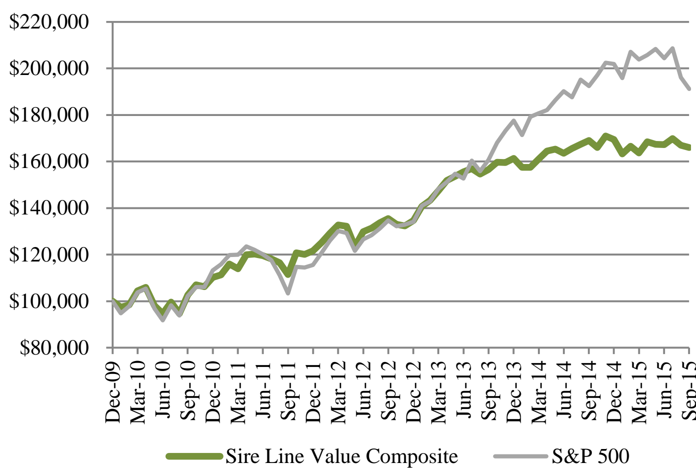
Performance Report from
Daren Taylor, Portfolio Manager

Figure 1: THE VALUE OF A $100,000 INVESTMENT IN THE SIRE LINE VALUE COMPOSITE FROM INCEPTION (1/4/2010) TO PRESENT (9/30/2015) 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 small decline of 0.7% over the three month period ending in September vs. a larger loss of 6.4% for the S&P 500 (and a 7.0% loss for the Dow Jones Industrial Average). Over the last six months the SLVC has actually gained 1.5% vs. a loss of 6.2% for the S&P 500 (-7.3% for the Dow). And year to date our composite is down 1.9% vs. a decline of 5.3% for the S&P 500 (-7.0% for the Dow). The favorable relative performance of our portfolios this year has primarily been driven by gains in our short positions (protective hedges).

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%**
2015YTD	-5.3%	-7.0%	**-1.9%**
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%**
2010-2014	101.9%	91.6%	**69.4%**
2010-2015YTD	91.2%	78.3%	**66.1%**
Annual Compounded Rate:	11.9%	10.6%	**9.2%**

(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.*

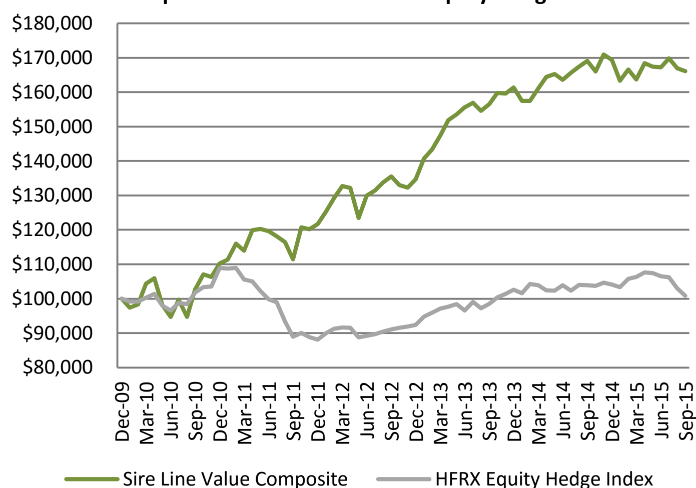
Our relative underperformance over the last two years is primarily a result of the losses that we have experienced in our short positions (protective hedges) partially offsetting the gains in our long positions (long-term investments). Remember that I began to hedge our portfolios in late 2013 when I felt uncomfortable with the increasing level of market risk. As it turns out I was a little early. The Russell 2000 Index of small-cap stocks, which has been the focus of most of our hedging over that time, continued to increase in value through 2014 and our short positions lost value

as a result (the value of a short position is inversely correlated to the price of the underlying security). However, if faced with the same situation again in the future, I'm not sure I would do anything different. As Warren Buffett once quipped, "Noah did not start building the Ark when it was raining." Our patience is paying off this year as the Russell 2000 Index has declined 9% through September and is down 15% from its high reached in the summer.

Even though our year-to-date numbers show a small decline, I am actually quite pleased with our overall performance. The S&P 500 and the Dow are down 5%-7% over the same period. In addition, some very smart professional money managers that manage billions of dollars for their partners and clients have experienced double-digit losses so far this year. David Einhorn, who runs the portfolio at Pershing Square Capital, is down 17% year to date. Donald Yacktman, who manages the Yacktman Funds, is down over 12%. Mario Gabelli's Gabelli Value 25 Fund experienced a loss of nearly 12% in the third quarter alone. And Mason Hawkins' Longleaf Partners Fund is down 23% this year through September. These are all very smart professional money managers with enviable long-term performance track records that manage billions of dollars of their clients' assets. I hope you are as pleased with our performance as I am. *(Added note: Our portfolios have bounced back since the end of September and the SLVC has gained over 5% in the month of October.)*

Since I manage all of our portfolios for absolute performance (I absolutely detest losses, even small ones!), it is probably more appropriate for me to compare our performance to other absolute-oriented indices such as the HFRX Equity Hedge Index (HFRX). The HFRX is designed to reflect the performance of the equity hedge sector of the hedge fund universe, as compiled by Hedge Fund Research, Inc. As you can see in the next chart (Figure 3), the SLVC has significantly outperformed this benchmark since inception.

Figure 3:
SLVC net performance vs. the HFRX Equity Hedge Index



Risky Business

Our short positions (protective hedges) performed as expected in the volatile third quarter. Gains in our hedges mostly offset losses in our long-term investments, which declined in sympathy with the overall market. Why do I use protective hedges in our portfolios? As I have mentioned to you before in past reports (repetition is needed when discussing risk), every investor in the stock market faces two primary risks: firm-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 some shocking global event or a sudden deterioration in certain macro factors, cannot be diversified away.

There are two ways that I manage market risk. First, I only invest in high-quality businesses that I can purchase at a significant discount to my calculation of intrinsic value. Buying a stock at a discount to the firm's underlying business value provides us with a margin of safety, limiting our downside if the market in general should decline. And the other way I manage market risk is by holding high cash reserves and shorting the most overvalued segment of the market when I perceive market risk to be high. Small-cap stocks are one of the most expensive asset classes today and that is the reason for our significant short position in the Russell 2000 Index (small-cap stock index).

The significant volatility in global equity markets during the third quarter reflects the heightened level of market risk in the current environment.

Richard Rainwater: A Great Investor

"Once I've determined what to do, I go forward. I fight despair with facts, and overcome greed by being generous." -Richard Rainwater

Richard Rainwater, who many consider to be one of the greatest investors of our time, passed away at the end of the third quarter at the age of 71 after a long battle with a rare and incurable brain disease called progressive supranuclear palsy. Working out of his office in Fort Worth, Texas, Richard was best known for managing money for the legendary Bass Brothers of Texas. Over a span of 16 years (from 1970 to 1986), Richard turned the Bass Brother's $50 million oil fortune into a $5 billion mega fortune by investing wisely in high-quality public companies.

As a kid growing up in Midland, Texas, I didn't have a clear picture of what the financial world was all about. It was only after I had been in New York for a few years that I started to get interested in investing. In the early 1990s I began to read anything and everything I could get my hands on about financial markets and investing. My primary goal at the time was to figure out who the best investors were and to learn as much as I could about what made them great investors and who influenced their investment

philosophies the most. Not too far into my journey I noticed that a few names kept popping up. You know the usual suspects as I have quoted them many times before in this quarterly report and on our website: Warren Buffett, Charlie Munger, Ben Graham, Philip Fisher, Peter Lynch, Seth Klarman, Bill Nygren, Donald Yacktman, among others. One of the "others" was Richard Rainwater.

At the time I was looking for an identity and foundation for a solid approach to investing. When I first read about him, I instantly understood Richard very clearly. Maybe it was also the fact that we were both Texas boys that allowed me to relate to him better than others. But the impact he made on me was immediate.

Many of the principles that defined Richard's investment style (which are also similar to Warren Buffett's Investment tenets) are deeply imbedded in my value-oriented approach to investing today. One important tenet that Richard emphasized was to always have a high-quality management team running the show. He would say, "Go with the team, not the concept." I never forget this quote when I am evaluating an investment opportunity.

Another important tenet of Richard's investment philosophy that has carried over into my investment philosophy was that if an investment idea seems too complicated, don't even try to value it. Just turn the page and move on to the next potential opportunity. My favorite quote of his on this topic is "If you can't pencil it out on the back of an envelope, it isn't worth doing." Warren Buffett talks about having a clear understanding of how large your circle of competence is and always making sure you stay within that circle when making investment decisions. Buffett has his circle and Richard has his rectangle (envelope), but they are basically the same principle. This simple advice has kept me from making some bad investment decisions.

But probably the most important thing that I learned from Richard Rainwater is that the only way to truly create wealth is to run a focused portfolio by taking large positions in your best ideas. One of my favorite quotes of his on this topic is the following: "When I see a unique and remarkable opportunity, I commit quickly and I invest heavily, because if I don't, someone else will."

Most professional money managers and individual investors believe that they need to diversify their assets widely across many asset classes and across a large number of securities. But this kind of significant diversification doesn't just limit your downside, it also limits your upside. Donald Yacktman, another great Texas-based investor that has been a big influence on me, put it this way: "Too much diversification is a kind of ignorance, one that betrays a manager's lack of confidence in picking stocks." Another great investor who has created significant wealth by taking large positions in his best ideas is Warren Buffett. At the 40-year mark in his career, Buffett said, "Twelve investment decisions in my career have made all the difference."

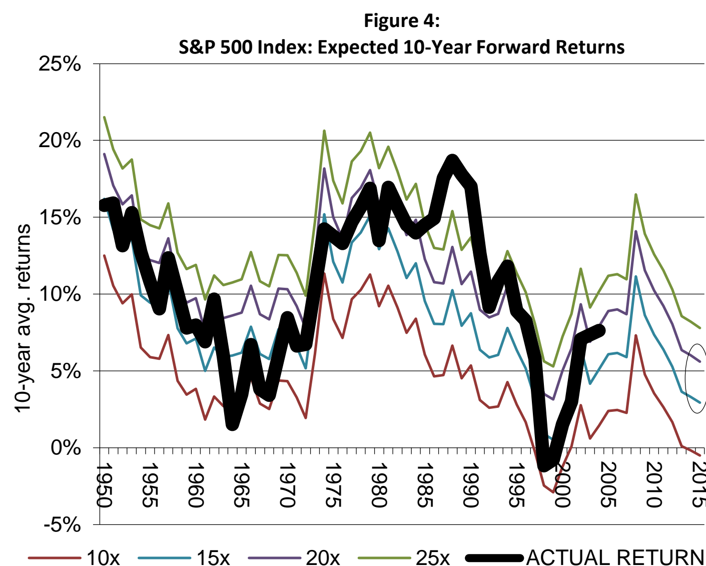
Individual investors can't create significant wealth by diversifying their assets across many different asset classes and hundreds of different securities. The only way to create true wealth is by taking significant positions in your best ideas and having the patience and courage to wait for others in the market to recognize the value that you know is there.

I owe a great deal to Richard Rainwater for being such an important influence on me and my approach to investing. Probably more than even I know.

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.

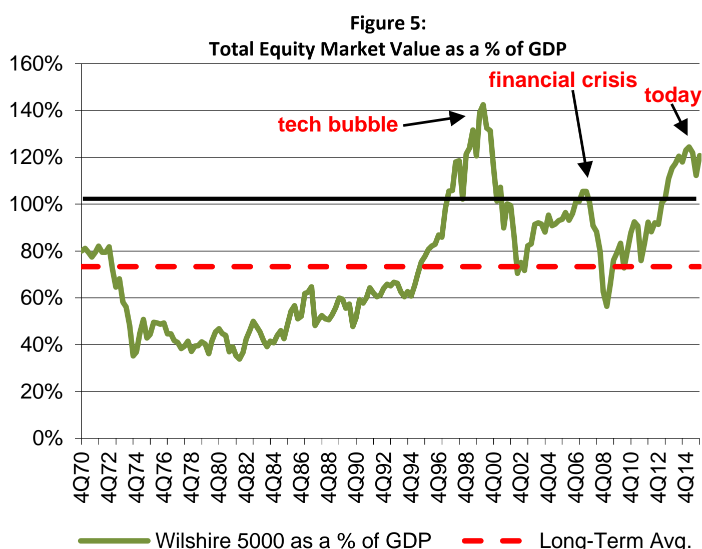
Figure 4:
S&P 500 Index: Expected 10-Year Forward Returns



In Figure 4 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 3.0%–5.5%, 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 around 2%, it implies a price return of just 1.0%-3.5% 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).

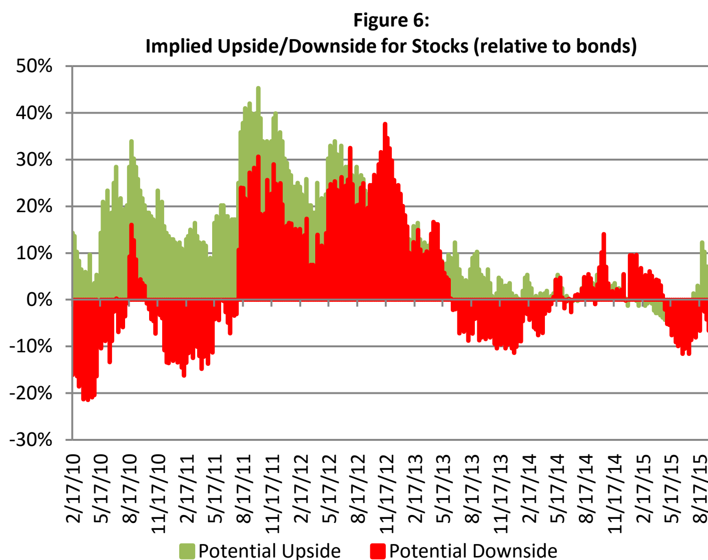
With the Wilshire 5000 Index valued at over $21.6 trillion and current GDP of roughly $17.9 trillion, the current ratio is around 121%. This is significantly higher than the long-term average of around 73% (long-term median = 67%). In addition, as you can see in the following chart (Figure 5), there 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 and following the recent selloff in stocks in the third quarter, the current relationship implies roughly 10% upside for stocks. You can see this more clearly in the next chart (Figure 6).

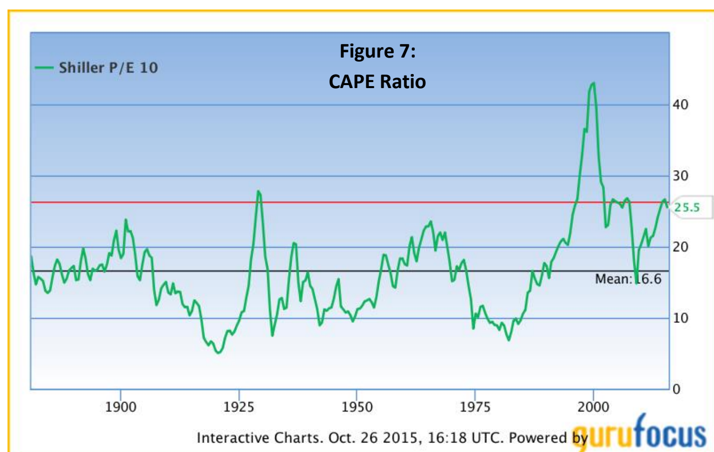


And finally, the most common valuation metric used by those investors that continue to believe current equity valuations are attractive is the price-to-earnings (P/E) ratio for the S&P 500 Index using forward earnings. The argument goes that the current P/E ratio of roughly 16.8x is only slightly higher 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 8) shows the history of this measurement going back over 100 years.

Based on this measurement, the current value of 25.5x has only been eclipsed in two prior periods looking back over the last hundred years—1929 and 1999 (see Figure 7 on next page).



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

Given that these and other broad valuation measurements continue to look overextended, all of the portfolios that I manage 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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