SIRE LINE
Capital Management

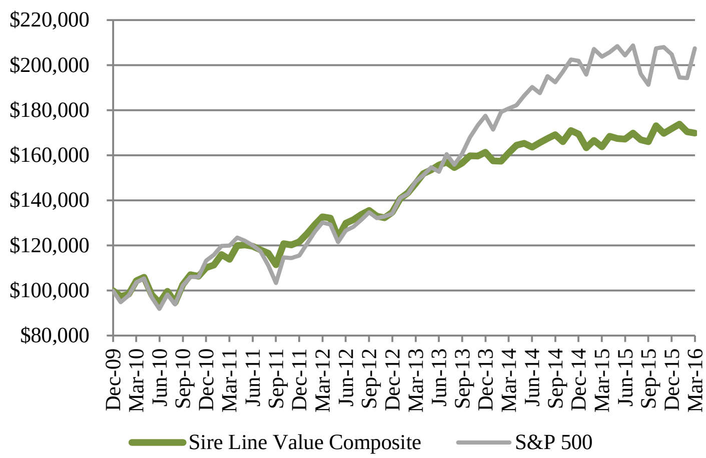
FIRST QUARTER REPORT

159 Madison Avenue, Suite 10i, New York, NY 10016 | (646) 526-8403 | info@sirelinecapital.com | www.sirelinecapital.com

May 1, 2016

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 (3/31/2016) 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

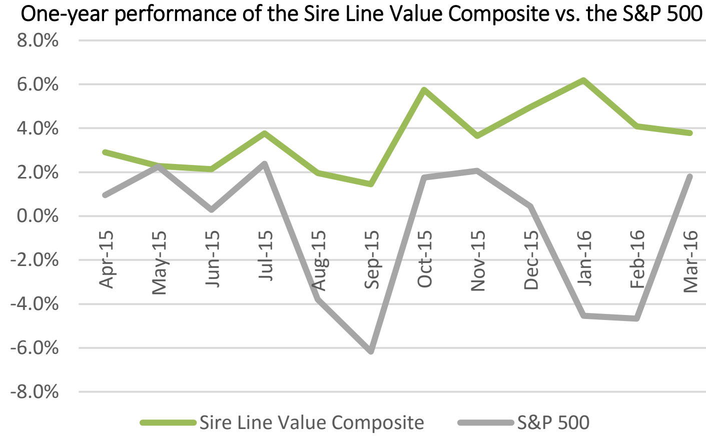
The primary objective for all of our portfolios is to achieve the maximum long-term total return on capital that is obtainable with minimum risk of permanent loss. The chart above (Figure 1) shows a comparison of a $100,000 investment in the Sire Line Value Composite and the S&P 500 Index (S&P 500) since 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.

Performance

The Sire Line Value Composite (SLVC) experienced a small loss of 1.1% over the three-month period ending in March vs. a small gain of 1.4% for the S&P 500. The average U.S. diversified equity mutual fund also experienced a small decline in the first quarter. The final numbers are deceiving as our portfolios actually outperformed the S&P 500 for over 90% of the quarter. And while I don't like losses, even over a short period of time, I was quite pleased with our risk-adjusted performance. Within the first few weeks of the quarter, the S&P 500 had dropped over 10%. It was the worst start ever to a calendar year for the S&P 500. However, our portfolios never experienced more than a slight decline at any point during the quarter. Our hedges performed as expected.

Over the last twelve months, the SLVC gained 3.8%, outperforming the S&P 500, which showed a gain of 1.8%. Again, the headline numbers don't tell the entire story as equity markets experienced tremendous volatility over that time period while our portfolios remained much more stable. As you can see in the next chart (Figure 2), the S&P 500 was in negative territory for much of the past year while the SLVC never went into negative territory.

Figure 2:
One-year performance of the Sire Line Value Composite vs. the S&P 500



As for our relative underperformance over the last 2-3 years (see Figure 1 on left), it is primarily the result of my being overly conservative as market risk has continued to increase over that time. As a reminder, I reintroduced hedging to the portfolios in late 2013 and gradually increased the weighting of our hedges during 2014. It has been about a year since our portfolios have been "fully" hedged, and as you can see in the chart directly above (Figure 2), it has been a good strategy. We have experienced moderate gains while being exposed to minimal downside risk. Not once but twice over that time, the S&P 500 experienced declines of over 10%. I believe this significant volatility is a reflection of the fragile state of global equity markets. I continue to feel uncomfortable with the heightened level of market risk in the current environment and unsatisfied with the implied forward rates of return reflected in the valuations of most asset classes. Therefore, our portfolios remain conservatively positioned.

The following table (Figure 3) summarizes the historical performance of the S&P 500, the Dow Jones Industrial Average (Dow) and the Sire Line Value Composite (SLVC):

Figure 3:	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%**
2015	1.4%	0.2%	**1.4%**
2016YTD	1.3%	2.2%	**-1.1%**
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%**
2010-2015	104.7%	92.0%	**71.8%**
2010-2016YTD	107.5%	96.2%	**69.9%**
Annual Compounded Rate:	12.4%	11.4%	**8.9%**

(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.

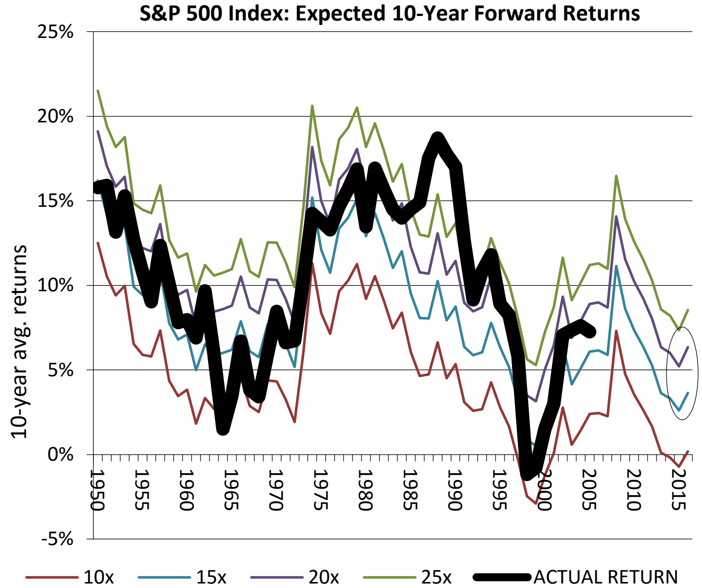
(4) Based on changes in the value of the Sire Line Value Composite including dividends and after all fees and expenses.

U.S. Equity Markets: Cheap or Expensive?

One measurement that I follow closely to gauge the current investment environment 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.

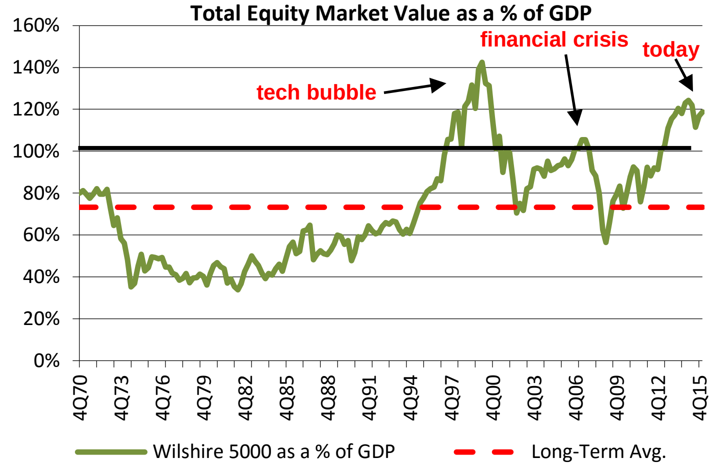
In the next chart (Figure 4), the thin colored lines represent expected 10-year forward rates of return for the S&P 500 Index assuming future earnings grow at a 4% average annual rate (6% pre-2010) and a range of P/E multiples (10x, 15x, 20x and 25x) in the final year. The heavy black line shows the 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 3.7%–6.3%, 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 and we all know how well that turned out. In addition, given that the dividend yield on the S&P is currently 2%, it implies a price return of possibly only a little over 1.7%—4.3% per year going forward.

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



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).

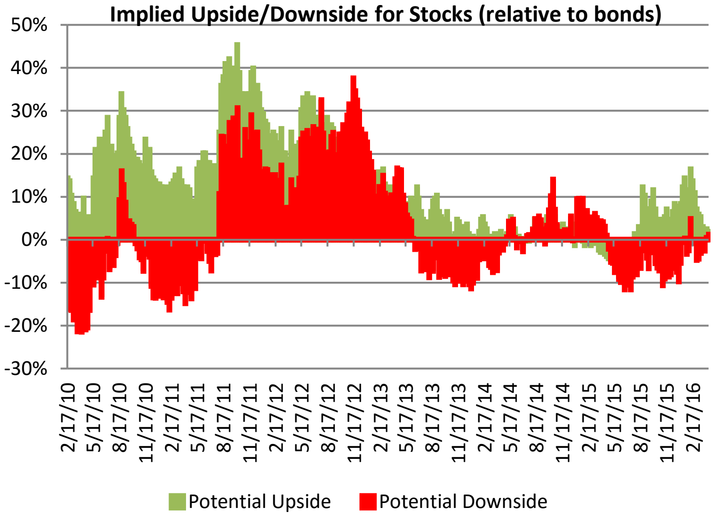
Figure 5:
Total Equity Market Value as a % of GDP



With the Wilshire 5000 Index valued at close to $21.5 trillion and current GDP of roughly $18 trillion, the current ratio is around 120%. 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. Neither of those turned out very well.

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.

Figure 6:
Implied Upside/Downside for Stocks (relative to bonds)



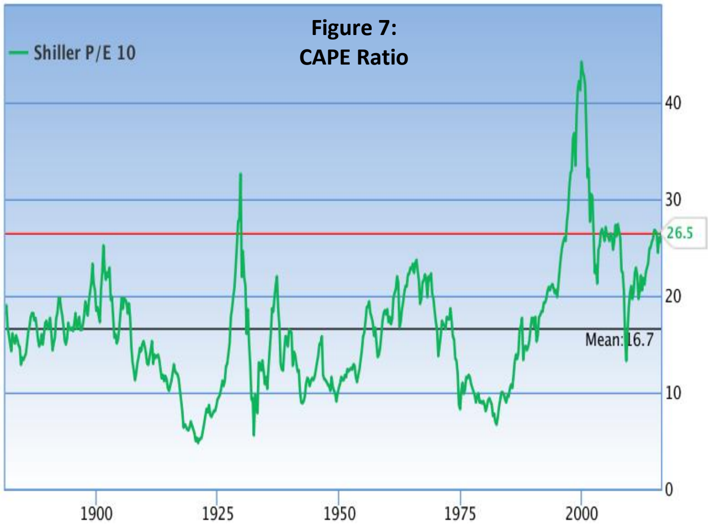
Based on the historical relationship between these two yields, the current relationship implies minimal upside for stocks in general. You can see this better in the previous chart (Figure 6).

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. The argument goes that the current forward P/E ratio of roughly 17x 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 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 management teams. 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 26.5x has only been eclipsed in two prior periods looking back over the last hundred years—1929 and 1999 (see Figure 7). Its historical mean is 16.7x, 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, our portfolios will remain conservatively positioned until conditions improve.

The First Saturday in May

Last week I traveled out to Omaha to attend Warren Buffett's annual shareholders meeting for his company, Berkshire Hathaway, as well as other value investing gatherings. (That's right, we are all part-owners of Warren Buffett's company!) This is the first year that I actually enjoyed the big Buffett show live as it is usually on the first Saturday in May, which is also Kentucky Derby Day (a man has got to have his priorities!). This year the Berkshire meeting was a week before the Derby. Almost every year for the past few decades, the Berkshire Hathaway shareholders meeting shared the same day as the Kentucky

Derby. However, this is not the only connection that Buffett has to the world of horse racing.

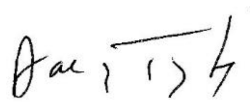
When Warren Buffett was a teenager growing up in Omaha, he loved going to the local racetrack, Ak-Sar-Ben, all the time to watch and handicap the races. He was too young to bet, but he and a good friend of his produced (in their basement) and sold a tip sheet to the adult gamblers called Stable-Boy Selections. The track eventually stopped allowing the boys to sell the tip sheet on the premises because it was cheaper than other handicapping programs sold at the track (which the track was actually getting a commission on) and Buffett's analysis was actually quite good (he was stealing business from the other programs). Buffett was so interested in learning how to profit from analyzing horse races that when his father became a Congressman and had to move the entire family to Washington DC, Warren's first request when he arrived in Washington was to ask his father to go to the Library of Congress and bring home every book they had on horse handicapping. Who doesn't love Buffett?

As Alice Schroeder correctly pointed out in her book, The Snowball, handicapping horses combined two things that Buffett was very good at, even at a very early age: collecting information and math. Those are two things that I am also good at, which is probably why I am so attracted to the world of horse racing and to Warren Buffett. I also have a great fondness for the equine athlete, which is a bonus.

Enjoy the 142nd running of the Kentucky Derby this week. Not many things survive 142 years. It is a wonderful American tradition.

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
dtaylor@sirelinecapital.com