Market and Portfolio Update

We have given significant thought and studied the current market climate with the goals of how to position your portfolio and understand the risks and opportunities. Our conclusions are discussed below and they may be of interest to you. In our view the current market environment can be characterized by overvaluation, momentum, and bifurcation.

Overvaluation

Valuation levels for the broad stock markets by nearly any measure (e.g. Price to Sales, Price to Cash Flow, Value line Median P/E, Market Cap to GDP) are at or near multi decade highs, with the exception of the 1999-2000 market. In addition, corporate profitability is near record highs due to low interest rates and a continued focus on expense management. If one believes that interest rates will remain near zero percent for the next 10+ years than current stock market valuations may appear reasonable or fairly valued. We do not believe that 0-3 percent interest rates are a permanent condition and the risk/reward in the broad markets appears unfavorable. While anything can happen in the short term broad markets are not poised for sustainable long term returns from these valuation levels.

Contrast this with the valuation of our equity portfolio which is significantly less expensive than the broad markets and offers the most value of any portfolio we have managed at any point in time in our careers. If we divided the portfolio into two buckets, one measured by cash flows and the other by book value or net asset value, we find the first bucket filled with a collection of above average businesses trading at below average prices. The second bucket is made up of companies that are trading at or near book value/net asset value and have historically traded at multiples significantly above current levels. This bodes well for the patient investor.

Momentum

"Bloomberg reports momentum stocks, or shares with the most price appreciation in the last 2-12 months, are rising three times as fast as the S&P 500 this year, on par with the best years ever recorded"

This means people are buying things because they have gone up a lot and selling things because they have gone down a lot. [1] As value investors like us, this presents a difficult challenge. The fundamentals are overshadowed by momentum and little regard is paid to business quality or long term value. While

[1] http://kopernikglobal.com/sites/default/files/Its%20Still%20Rock%20and%20Roll%20To%20Me.pdf

the current environment seems to represent a popularity contest we expect business values to bear out and the incredible values in our portfolio to be realized.

Another example of momentum and bifurcation in the markets was highlighted in asset manager FPA Capital's June 30, 2015 quarterly letter.

"At the end of the quarter, we ran a quick analysis and looked at what type of companies have accounted for the Russell 2500's outperformance relative to other benchmarks. The results were fascinating: In the first six months of the year, almost 150 companies experienced stock price increases of more than 50%. 60% of these companies were biotech, pharmaceutical, or other healthcare. When we looked at the subset, we were shocked to learn that 80% of them were unprofitable and they, in aggregate accounted for $145 billion of market capitalization and more than $3 billion of cumulative net losses."[2]

Bifurcation

Wintergreens Funds reports, "If you did not own the top 25 gainers, you missed out on over 50% of the S&P's overall returns. The technology sector contributed to an astounding 29% of the return, health care 26%, and financials 19%-overall these three sectors contributed to over 74% of the S&P's performance. Apple, Microsoft, Facebook, and Intel alone accounted for over 20% of the S&P's return in 2014."[3]

In fact four stocks out of 500 accounted for more than 1/5 of the markets return in 2014.

Stealth corrections are taking place across the market and in specific sectors. Day Hagan asset management published the following from their research.

"The U.S. equity markets continue to evidence deterioration beneath the surface. For example, based on the largest 4000 publicly traded companies on U.S. exchanges, more than 45% of those companies, or 1,804 of them, are 20% or more below their 3-year highs. Furthermore, 24.09% of those 4000 companies are 40% or more below their respective3-year highs (we use 3-year highs to eliminate misleading short-term spikes that could skew results)." [4]

We continue to keep a close eye on new opportunities and are building our research database so at the right price we can take advantage of them. High quality companies such as Whole Foods, Ralph Lauren, Wal Mart, B/E Aerospace, Core Labs, Mead Johnson, and many more, are as much as 20-50% of their recent highs.

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[2] http://www.fpafunds.com/docs/hc_capital/q2-2015-capital-commentary-with-disclosures-1.pdf

[3] http://www.wintergreenfunds.com/downloads/wintergreen_fund_annual_report_20141231.pdf

[4] http://dayhagan.com/current-view-august-7-2015/

While History does not repeat it does rhyme

With this picture of the current market environment today, a look back into history may suggest how these types of environments may play out. In the early 1970's the Federal Reserve and Arthur Burns used easy money policies to boost the economy. Out of this environment came the "Nifty Fifty". The nifty fifty stocks emerged as the investments to own and were considered one decision stocks. They could be bought and held forever due to their continued and promising growth. DuPont, Eastman Kodak, Exxon, Ford, General Electric, Xerox, IBM, Phillip Morris, Sears,etc) were all part of this group. Momentum took hold, and a narrower and narrower group of stocks rose to incredible highs while most other stocks were falling. No price was too high until gravity emerged. The nifty fifty along with the markets declined meaningfully, despite the fact that throughout the stock price declines business fundamentals (Sales and Profits) for the nifty fifty improved. At the end of this significant decline, in the mid 1970's, many of these great companies traded at single digit P/E's with dividend yields of 5-6% which represented incredible values.

We saw these same characteristics again in the 1999 and 2000. Technology, media, and telecom were the main drivers of stock market growth in the late 90's while "old economy" stocks declined. During this time tobacco, railroads, consumer staples, insurance company stocks declined meaningfully while the broad markets charged higher. Useful valuation metrics were ignored and new ones were created- i.e. Eyeballs and clicks were counted while cash was not. Once again gravity took over. The indexes declined and it ended up being a "lost decade" for the S&P 500. From 2000 to 2010 the total return in the S&P 500 was +4.63% or .41% annually[5]. It wasn't a lost decade for us! The things to own into 1999-2000 were the things "not" to own in the following decade. The "old economy" stocks which performed poorly in the late stage momentum markets of 1999-2000 went on to generate long term sustainable returns for the owners who relied on fundamentals and continued to own positions despite the opinions of the media and wall street. During a difficult investing period for Warren Buffett in the 1999-2000 "new era", Berkshire Hathaway stock declined approximately 30% and he was considered out of touch. His words ring true today and he reiterated his conviction that valuations determine long term returns and those that are looking at the future through the rearview mirror are likely to be disappointed.

We see many parallels today and the setup looks similar. While each environment and time period is naturally different, human nature remains the same. The current environment favors promise over profits. Themes continue to play out to the extreme on both the upside and downside. We have been through a unique period for our clients, however there is no such thing as a permanent trend in the markets. We expect the overvaluation, momentum and bifurcation to change and we are positioned to do extremely well on both an absolute and relative basis. We continue to utilize the current environment to your long term advantage. The downside momentum and the markets desire to ignore good and improving fundamentals and focus on price action has allowed us to establish new positions in many high quality companies in and build out our "buy" list as the market declines have begun in a fast and furious manner.

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[5] 2015 Bloomberg Finance L.P.

Successful investing requires patience and flexibility. Paying attention to valuation generally leads to superior investment returns. We continue to be impressed with the patience our current clients have exhibited. Patience isn't always easy when value focused styles remain out of favor, but it may be helpful to remind oneself that the decades following 1972 and 1999 clearly rewarded value investors.

Portfolio Update

We continue to review and manage your portfolio with the goal of reducing risk while maintaining the meaningful upside within the portfolio today. In a world and market environment where uncertainty and valuations remain high we choose to focus on things we can control. The focus is on value, portfolio balance, and sensible diversification. Fixed income remains an integral piece of the portfolio providing stability and income generation. The equity strategy is a combination of capital allocators/owner operators, "blue chip" companies, and inflation beneficiaries. Our equities represent incredible value at today's prices. We have recently increased the cash for added portfolio stability, with the expectation that it will be sensibly deployed into future opportunities as they appear. The significant cash and liquidity provide the peace of mind to stay the course. We are confident in our ability to invest profitably over time and for the long term.

We sincerely thank you for your continued interest and trust.

Roger, Brian, and Heidi

Grefe Capital Management of Raymond James

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