ADDING VALUE

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This issue of Adding Value describes in some detail the current capital market conditions. [The S&P 500 Index has enjoyed a robust year to date, outpacing every index in the world.] At times like these, it is important to review the differentiation between investment and speculation that first appeared in Benjamin Graham's (the father of modern investment theory) Security Analysis:
"An investment operation is one which upon thorough analysis promises safety of principal and adequate return. Operations not meeting these requirements are speculative."

COMING INTO THE 2013 HOME STRETCH

Coming into the 2013 home stretch, it is very difficult to decide which end is up. Ben Inker of GMO wrote at the end of July:

"The S&P 500 Index is up 20% year-to-date; however, no broadly diversified portfolio is up 20%:

- a Global 60/40 portfolio is up approximately 7%,
- a U.S. 60/40 portfolio is up approximately 10% and
- while U.S. equities are the world's best performing asset class in 2013 so far, the U.S. bond market is down close to 5%.

From May 22 to June 24, 2013, the S&P 500 lost 5.6%, MSCI EAFE lost 10.1%, MSCI Emerging Markets fell 15.3%, the Dow Jones/UBS Commodity index fell 4.5%, the U.S. 10-year T-Note fell 4.4%, and the Barclays U.S. TIPS index fell 7.1%. For good measure, the J.P. Morgan Emerging Debt Global index fell 10.8%, the German 10- year Bund fell 5.2%, the UK 10-year Gilt fell 3.4%, and the Australian 10-year bond fell 6.5%. Equity markets have made a fairly sharp recovery since then, with the S&P 500 actually hitting new highs, but lots of other asset classes are still licking their wounds.

For instance, emerging markets are down over 10%, Biotech is up more than 40%. The Market Vectors Gold Miners ETF is down over 35%, the SPDR Gold Shares is down 18%, the SPDR Regional Banking ETF is up over 32%, the Vanguard REIT ETF is flat, Health Care is up over 25% and the Vanguard Total World Stock Market ETF is up 11%."

Our fondest wish would have been to predict any of this in January 2013!

INVESTOR OR SPECULATOR?

Broadly diversified portfolios will always underperform the top performing asset class at any given time. Put another way, we will never have the best-performing portfolio because our portfolios are always diversified. This is true all the time. However, when the S&P is the top performing asset class in the world (as the case is in 2013), somehow it seems much worse to have a portfolio that is lagging this benchmark. This is a home country bias and at the risk of oversimplifying, this seems to be a psychological blind spot of some U.S. investors. (Don't worry it's much worse in Japan!) At these points in time, it is important to remember the definition of investing vs. speculating. Investing is about broad risk diversification; speculation is

ADDING VALUE is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research with our clients.

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about taking targeted bets. Even though investing solely in the U.S. seems to be a wise decision in 2013 - - on the global market stage, it is still targeted and therefore, a risky bet.

Our process emphasizes the management of risk. We do not choose managers based solely on past performance. Instead we identify managers whose philosophies are complimentary, and if possible, non-correlated to each other and who are shareholder-oriented.

HOW DO YOU MAKE RISK YOUR FRIEND?

As Deepak Chopra states:

"In a competitive society, success is all but impossible without taking risks. There are few cushions or guarantees in the corporate workplace, but looking at the larger picture, all of us face decisions that could turn out badly. We take leaps of faith, large and small. We place trust in others. We count upon predictions and trends that could reverse at any moment. Risk is simply another word for uncertainty and it has been shown many times that uncertainty increases stress. Therefore, how you handle risk will be vitally important to your comfort, your stress level, and ultimately your success."

Psychologists have shown that it is impossible to remove emotions from decision making. Therefore, to handle risk well, you must consider your psychological reaction to it. If you know yourself well enough, you can make risk your friend. Here are the guidelines:

1. Know your anxiety level and be honest about it.
2. Be patient with your emotional reactions.
3. Be rational, but don't be fooled that reason can defeat risk.
4. Gather as much useful information as possible.
5. Take in other points of view.
6. Don't trust the crowd.
7. Don't believe that trends are the same as certainty.
8. Arrive at your own conclusions independently."

In our client portfolios we are making friends with risk by verifying that there is cash to meet all anticipated demands for at least three years, we are researching and adding new managers that add to the diversification of the portfolio, and we are over-weighting managers with a higher proportion of cash. The risk-reduction strategy and in-depth research has also led us to an interesting observation which we describe in the next section.

WHAT NOW FOLKS?

As most of our clients know, we try to buy securities when the stock price of a company is below the calculated intrinsic value of a company. This gives us a "margin of safety". In other words, we believe that if the long-term returns on the investments that you own are providing a 10% rate of return over an extended period of time, but the underlying businesses are actually growing faster, then there is a strong possibility that the stock price is too low and it will rise to reflect the business growth. The investment world is too competitive to allow these anomalies to last forever. We also believe that being invested alongside "owner operators", those managements that have a significant ownership stake in their business, is superior in most circumstances to being invested alongside "agent" managements. Owner operators enhance their wealth by getting stock prices of their companies higher; agent operators increase their salaries, bonuses, deferred compensation, golden parachutes and severance benefits without much thought to their shareholders.

Through our discussions you know that the mutual funds that we invest in tend to be independent companies led by strong individuals, with an independent philosophy and process. We do not generally use funds that are team-managed with a strong marketing (growth of assets under management) direction.

Interestingly, coming out of the financial crisis, the world has focused more on liquidity and being able to sell at a moment's notice. The market has even shunned mutual funds because you have to wait until the end of the day to obtain the

price at which you bought or sold. Exchange traded funds (ETFs) have become the vehicle of choice for liquidity in the post-2008 world. New money that is pouring into ETFs for the last 2 years has created an "ETF divide". As Peter Doyle of Kinetics Paradigm explains:

"The reason for the ETF divide is that ETFs desire money to flow into their products and they don't want to be constrained by liquidity. However, owner-operators have very large insider ownership positions; therefore the ETFs seek to minimize their representation by using a market cap, float-adjusted weighting approach, or by eliminating owner-operators completely because of their "illiquidity."

What does this mean? We think that stock price returns (investment returns) might be increasing faster than the intrinsic value of the business. The margin of safety is disappearing. Consider that most large cap companies are struggling to grow their revenue. In the first quarter of 2013, the top 20 non-financial companies in the S&P 500 had revenue growth of less than 2%. If you back out Google, the number becomes less than one-half of 1% revenue growth and of the top 20 names, 10 did not have revenue growth at all! It is difficult to grow your earnings if you can't grow your top line especially since companies have cut costs as much as possible and currently have record high profit margins.

Maybe the S&P 500 and some ETFs are expensive? But let's dig deeper.

Another way to think about this phenomenon is to examine the holdings in some ETFs.

Number of ETFs in which Selected S&P 500 Index Constituents are Top 10 Holdings

Company	# ETFs
ExxonMobil Corp. (XOM)	81
Apple, Inc. (AAPL)	69
International Business Machines (IBM)	78
Chevron Corp. (CVX)	67
Microsoft Corp. (MSFT)	67
Procter & Gamble Co. (PG)	63
General Electric Co. (GE)	54
Johnson &Johnson (JNJ)	68
AT&T, Inc. (T)	69
Pfizer Inc. (PFE)	61

Number of ETFs in which Selected Owner-Operators are Top 10 Holdings

Company	# ETFs
Brookfield Asset Management Inc. (BAM)	2
Sears Holdings Corp. (SHLD)	3
Liberty Media Corp. (LMCA)	4
Leucadia Capital Corp. (LUK)	3
Las Vegas Sands Corp. (LVS)	4
Howard Hughes Corp. (HHC)	0
Berkshire Hathaway Inc. Class B (BRKB)	20
Wynn Resorts Ltd. (WYNN)	3
Icahn Enterprises (IEP)	0
Continental Resources Inc. (CLR)	3

Source: Kinetics Paradigm Semi-Annual Letter

It is very interesting to note that the largest stock positions in the mutual funds in our client portfolios include the owner-operators to a greater extent than the top 10 holdings of the S&P 500 Index.

One other chart is useful as we examine what people are buying:

Net New Cash Flows ($ billions)			
Mutual Funds	**2013 (YTD)**	**2012**	**2011**
Stock Market Funds	$ 94.5	$(122.5)	$(98.7)
Money Market Funds	$ (87.5)	(76.8)	(62.4)
Taxable Bond Funds	$ 40.0	243.6	130.9
Municipal Bonds	$ (20.0)	52.7	(16.4)
Exchange Traded Funds	$ 107.4	152.8	99.1

Source: www.ICI.org

Just an observation, but investors seem to be headed to a place where they have been many times before - - buying what is popular and expensive, today it is taxable bond funds and exchange traded funds.

Is this a formation of another bubble? It is if one definition of a bubble is the flow of funds into a sector or securities irrespective of fundamental merit or valuation. When this situation occurs for too long, excesses arise. It is inevitable. Like all bubbles, it will reverse. When? We just cannot predict the timing. Therefore, we must be patient and rely on our valuation models, investment experience, and our independent thought process.

CONCLUSION

We have written in prior newsletters the importance of understanding on a deeper level the "noise" being delivered by the market. Presently, we are in a market where the "sky is the limit" and the contagion of past performance has inspired everyone to join the bandwagon. Since the best-performing asset class is large U.S. stocks, the hometown bias has further encouraged the flow of money. With stock returns exceeding 20% for the S&P 500 YTD, far greater than the underlying business's growth of earnings, the S&P is appearing to be a little expensive. Rather than joining the contagion, we are doing what is normal for us… looking below the surface, finding opportunities that are still cheap, and maintaining broad diversification.

Often, there is no correlation between the success of a company's operations and the success of its stock over a few months or even a few years. In the long run, there is a 100 percent correlation between the success of the company and the success of its stock. This disparity is the key to making money; it pays to be patient and to own successful companies. As quoted by Ben Graham, "In the short run the market is a voting machine. In the long run it's a weighing machine."

In conclusion, client portfolios are broadly diversified, the top holdings are with selected owner-operators, cash levels are rising in some of the mutual funds we own, <u>but</u> we are also underperforming the S&P 500. We think this situation will change. Always remember, the secret to making money is to be at the right place at the right time!

Sincerely,

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