2013 Q1 Newsletter

Market Update

The US stock markets had a solid first quarter and ended at all-time highs. Corporate profit margins are defying gravity at over 10% of GDP, or 70% above their historical average of 6% of GDP. In addition to companies continuing to run "lean & mean" since emerging from the Great Recession, they also are benefiting from the massive deficit spending by the federal government and record low household savings.

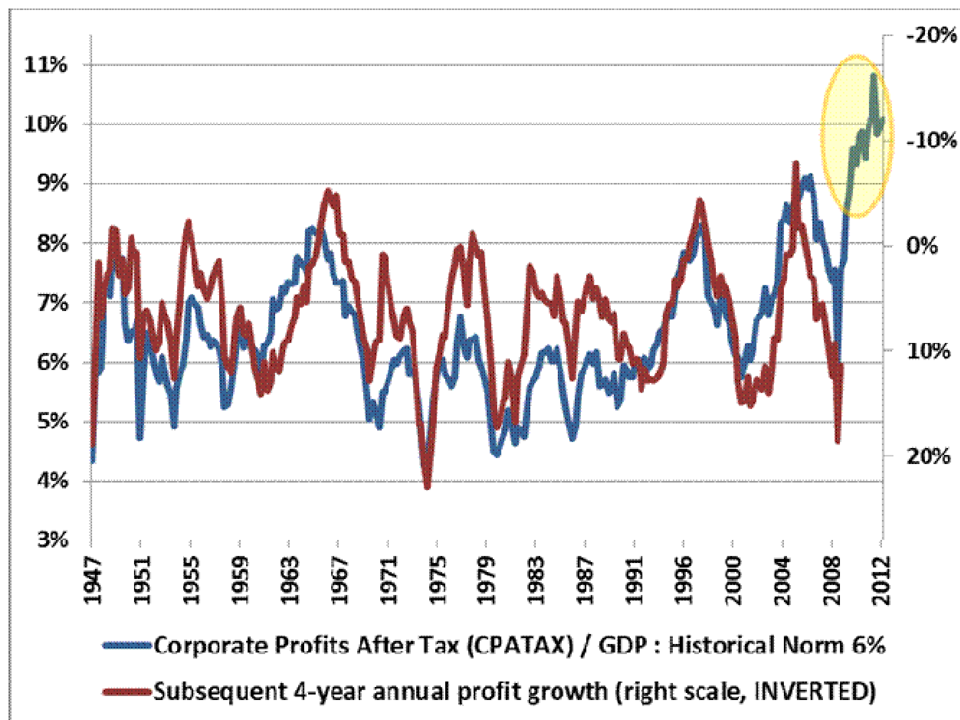

Chart courtesy of Hussman Funds.

The chart above indicates the record high corporate profit margins are now at a level where they are projected to decline at a rate of 12% per year for the next 4 years. As Warren Buffet once stated,

> "In my opinion, you have to be wildly optimistic to believe that corporate profits as a percent of GDP can, for any sustained period, hold much above 6%. Maybe you'd like to argue a different case. Fair enough. But give me your assumptions. The Tinker Bell approach – clap if you believe – just won't cut it."
> - *Warren Buffett, "Mr. Buffett on the Stock Market," Fortune Magazine 11/22/99.*

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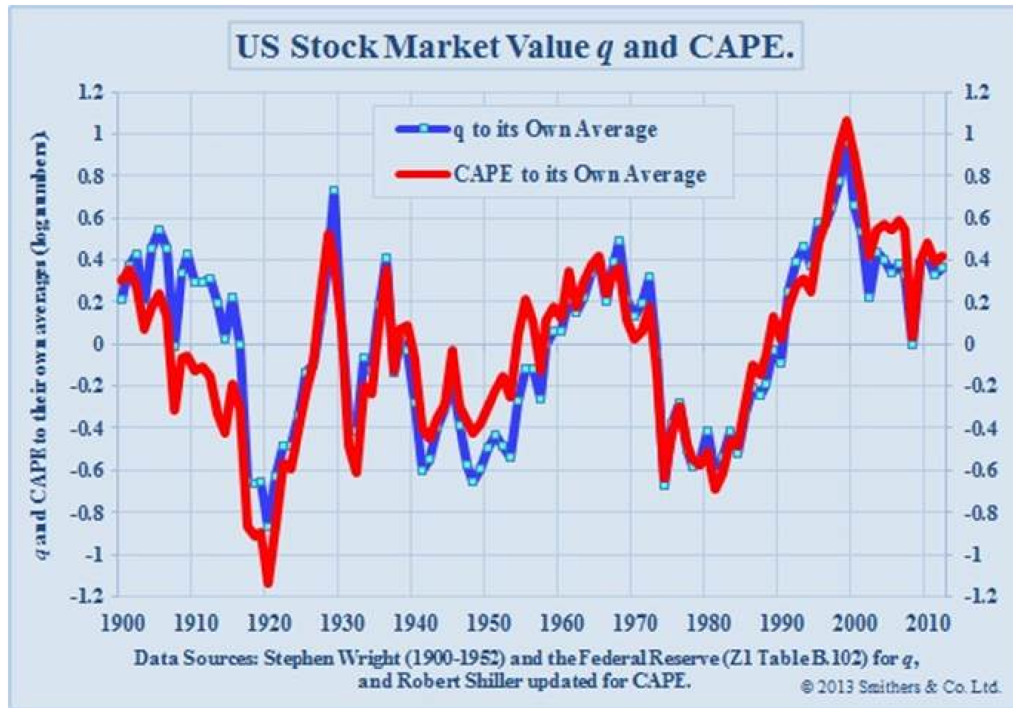
The stock market is priced for continued earnings growth. If profits decline, naturally, price will decline as well. Below are two different metrics depicting the stock market is 40% overpriced: Q ratio (replacement cost of the stock market's component entities) & CAPE (10-year PE).



So what does all this mean for stocks and bonds? Prospective US stock returns going forward are on average +1.1% per year for the next 7 years versus a historical return of +9.8%. Prospective US Treasury bond returns are slightly better at 1.3% per year.

GMO Annualized 7-year Return Projections for:	As of: 3/31/2013	Historical Return
US Large Equities	1.1%	9.8%
US Small Equities	-0.2%	11.3%
Int'l Large Equities	5.1%	9.8%
Int'l Small Equities	5.0%	N/A
Emerging Market Equities	8.1%	12.8%
US Government Bonds	1.3%	5.4%
International Government Bonds	0.2%	6.9%
Inflation Indexed Bonds	0.0%	7.1%

Put simply, stocks (and bonds) are not cheap, but are instead strenuously overvalued. Per John Hussman, "the speculative reach for yield, encouraged by the Federal Reserve, has created another bubble – which is not recognized as a bubble only because distorted profit margins create the illusion that stocks are reasonably valued. The likelihood of even these low prospective returns being achieved smoothly, without severe intervening volatility and steep market losses, is roughly zero. This does not imply or ensure immediate market losses, but it doesn't need to. On any horizon of less than about 6-7 years, we

expect that any intervening returns achieved by the S&P 500 will be wiped out, and then some. Speculate if you believe that your exit strategy will dominate that of millions of other speculators, despite market conditions that are already overvalued, overbought, overbullish and uncorrected. In my view, all of this will end badly".

Although it pains us to watch the stock market march higher on the back of what we believe to be unsustainable government intervention, we remain very concerned that all of the stock gains of the last 5 quarters will be erased and perhaps much more. The challenge is that we don't know when. We do believe that the forthcoming declines will be sooner rather than later. At more than 4 years in length, the current bull market is "long in the tooth". Of late, markets have been exhibiting topping tendencies. When the topping "rolls over" remains to be seen. The chart below is the S&P500 bull and bear markets since 1995. We are due for the next bear.

Portfolio Update

As stewards of your hard-earned savings, we continue to adhere to the following rules:

Rule #1: Don't lose Money.

Rule #2: See Rule #1.

We remain confident that our portfolio strategies are well-suited to whatever comes next. The following is an update of how our strategies fared in the first quarter. The benefits of our diversified approach are evident. This diversification hurt our performance as the US stock market temporarily outperformed most other asset classes. However, it is only the first quarter and there is a long way to go.

Summary of Investments and Q1 2013 Performance

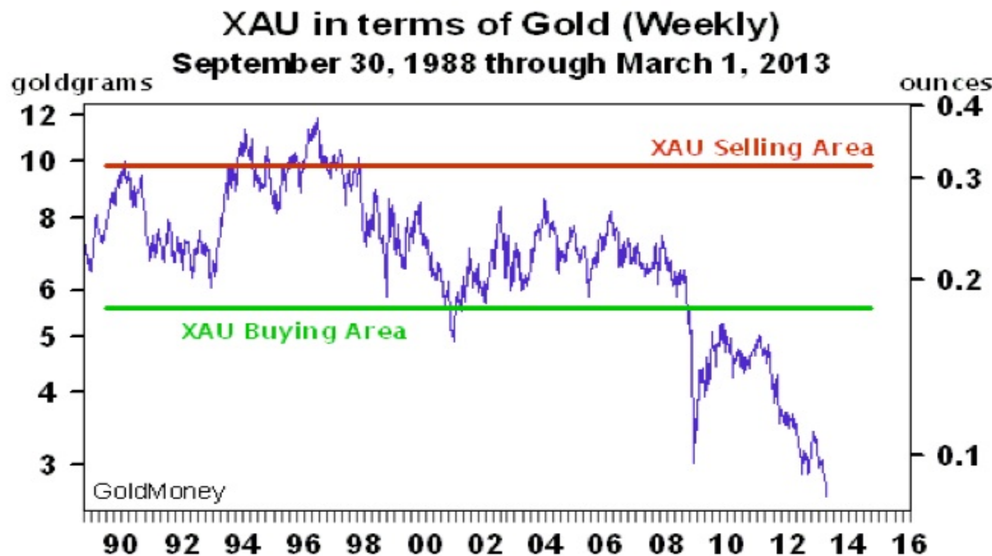
	Investment	Characteristics	Projected Annualized Return	1Q2013 Return
Safe & Steady	Doubleline Total Return	• Run by "mortgage bond king" • Low duration, high return bond fund	5-6%	1.1%
	Pimco All Asset	• Can invest in bonds or stocks • Reallocates according to perceived risk/return	5-7%	0.2%
	Pimco Total Return	• Diversified bond fund • Managed by bond manager of the decade, Bill Gross	4-6%	0.5%
All Weather Strategies	Sector Model	• Invests in best stock sectors during rising markets • Goes to treasuries during declining markets	15-25%	7.3%
	361 Capital	• US Equity timing model • Invested 20% of the time • Low correlation to stocks and bonds	15-25%	-1.3%
	Longboard	• Invests in 100+ asset sectors • Long or short • Low correlation to stocks and bonds	8-10%	3.6%
LT Growth at Reasonable	Japanese stocks	• Government embarking on Yen devaluation • Yen devaluation very good for stock prices	10-15%	17.1%
	Cheap countries	• Greece: -17.5% • Italy: -12.3% • Ireland: 13.3%	15-20%	-5.5%
	Emerging markets	• Best international growth prospects • Great demographics • Solid government financials	6-10%	-3.2%
	Gold Stocks	• Undervalued to gold bullion • Sovereign currency devaluations worldwide • Negative real interest rates persist	30-40%	-13.8%

Gold Stocks

As can be seen in the Summary of Investments and Q1 2013 Performance, gold stocks caused the most grief. The price of gold bullion declined 5.2% in Q1 and a further 12% through the 3rd week of April. Gold stocks have fallen much more. There are various possible reasons for the fall in gold and gold stocks. Since gold reached its high in August of 2011, the US dollar has increased 12% - it takes fewer dollars to buy an ounce of gold. India, one of the world's largest gold buyers (especially at the retail level) imposed a higher tax on gold imports. Institutional investors have rotated out of gold and are chasing the rising US stock market. It has been rumored that Cyprus may have to sell much of its gold to pay the bills. Iran pays for food and other imports with gold (due to trade embargoes) and western governments are suppressing gold prices to pressure Iran to clean up its act. The world is going into a

depression and a deflationary time. Regardless of the aforementioned, all of the fundamentals remain in place for higher gold prices in the future. The large western governments continue to print more and more money thereby devaluing their currencies. Investors are losing wealth (to inflation) owning US Treasury bonds, CD's or putting their money in the bank. It is important to note that while there recently has been a significant decline in the demand for "paper gold" in the form of ETF's and futures contracts, the demand for physical gold is outpacing the supply. In Hong Kong, lines are out the door at gold dealers with everyone buying and few selling. Yesterday, the US Mint suspended sales of American Eagle coins as sales have depleted the governments inventory. Gold and silver coin sales are up +40% for Q1 2013 versus Q1 2012. For April, gold coin sales are up 740% and for silver coins +57% compared with April 2012.

We liked gold stocks when the gold to XAU ratio got to a record high of 10.5. Recently that ratio is 13.5! Gold rises in price because it is a real asset of limited supply. It also rises in price if it is perceived to be a safe-haven alternative to sovereign currencies (those backed by the full faith and credit of their respective governments). Gold is the longest-standing, universally recognized store of value. We are surprised that the Cyprus bank account confiscations and the declaration that that act was a blueprint for other distressed nations didn't lead to a rebound in the price of gold. One theory is that it was intentionally suppressed. Regardless of the reasons for gold's recent price decline, we believe that the price decline is temporary and ultimately the price will be far higher. It is important to note that gold stocks constitute the most volatile stock sector. Prices can stay depressed for longer than seems rational. In the end, we believe that gold and gold mining stocks are going much higher.



In the above chart, "XAU" is an index of gold mining stocks. Relative to the price of gold, gold mining stocks are the cheapest they have ever been.

As promised in the last newsletter, the following discusses the remaining components of our current portfolio strategy.

Emerging Markets

Emerging markets are of interest because they offer the best growth potential for companies, especially compared with developed countries like the USA, Germany, France, Italy, the UK, Japan, etc. Typically emerging market countries like Brazil, India, Thailand, Vietnam, China and many others, tend to have younger, growing populations, burgeoning middle classes, low debt and very good economic growth. Emerging market countries tend not to be burdened with costly social programs and pension funds. As shown in the table on page 2, emerging markets offer the best annual return potential (8.1% per year over the next 7 years) of the major stock sectors. We do not suggest that the returns to be made from emerging markets will be without volatility, but over a 7 year period, they should exceed the US market.

Cheap Countries

One of our favorite investment themes is "cheap countries". The "cheapness" is measured by a country's 10-year cyclically adjusted PE ratio (CAPE). As seen in the table below, Greece is the cheapest country. No doubt it is cheapest because from an investment point of view, Greece is about as unloved as you can get. The Greek stock market is down more than 83% from its 2007 highs.

Country	Start Date	Latest Date	Latest
Greece	12/31/1987	3/31/2013	3.18
Argentina	12/31/1987	3/31/2013	5.17
Ireland	5/31/1990	3/31/2013	5.82
Russia	1/31/1996	3/31/2013	6.86
Italy	4/30/1984	3/31/2013	6.88
Austria	10/31/1981	3/31/2013	8.21
Spain	12/31/1979	3/31/2013	8.22
Portugal	1/31/1988	3/31/2013	9.89

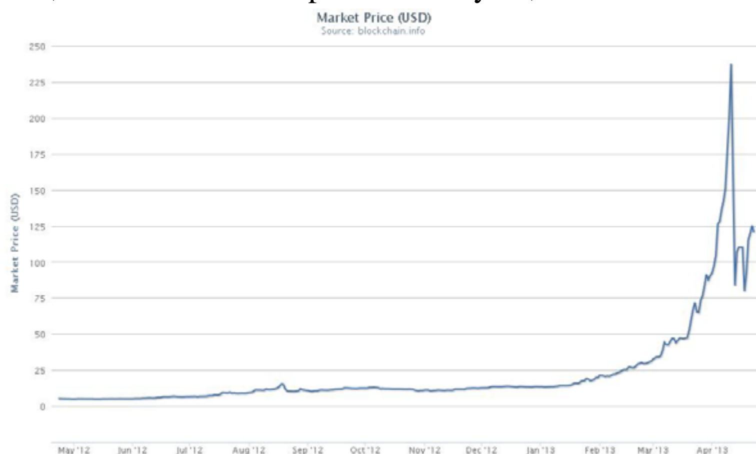
The most distressed countries are the cheapest and they offer the best return potential. The countries in the list above all have 10 year CAPE values of < 10. As shown in the table below, countries with 10 year CAPE values < 10 have historically returned 26% for one year and 17% per year for 5 years (plus inflation). These impressive returns are worth pursuing.

10-Year CAPE Levels and Future Average Real Compound Returns for 32 Countries 1980 - 2011

Avg CAPE by Bucket	% occurrence	1 Year Real CAGR	3 Year Real CAGR	5 Year Real CAGR	7 Year Real CAGR	10 Year Real CAGR
<10	10.2%	25.9%	17.0%	17.1%	13.4%	10.9%

Bitcoins – a new alternative currency

You may have heard about a new form of currency called “Bitcoins”. Bitcoins (BTC) came on the scene four years ago as an alternative to sovereign currencies. The beauty of bitcoins was supposed to be that they were global, non-denominational (not tied to or controlled by any government) and could not be delivered by helicopter! The supply of bitcoins is controlled by an independent peer-to-peer network of computer servers which “mine” bitcoin and introduce additional supply every 10 minutes. Bitcoin supply is intended to be capped at 21 million BTC in the year 2140. Most of the world’s currencies can be converted to bitcoins via a transfer of funds to an electronic bitcoin account at an exchange rate computed just like converting US dollars to Euros. With all of the global money printing underway and in the wake of the Cyprus fiasco, bitcoins are becoming increasingly popular. Assuming that there are no issues with the security to protect bitcoins from hackers and/or manipulators (security breaches have occurred), the concept sounds like a reasonable idea. Although there is supposed to be no sovereign manipulation of the bitcoin currency, there also is no sovereign backing of it. Bitcoins will retain their value as long as its users have faith in it. There has been just one problem with the whole concept. The exchange rate for bitcoin is proving to be incredibly volatile as can be seen in the chart below. In the summer of 2010 bitcoins were exchangeable for approximately $0.07 USD. Since then BTC got as high as $266 on April 10 and back down to less than $60 on April 12. As of April 18, BTC closed at $108. Indeed, from March 3 to April 3 of this year, BTC increased in value by more than 330%!



BTC just became a billion dollar “currency”. Is BTC going to replace the US dollar, Japanese Yen or Euro as the “world’s currency”? Probably not any time soon if at all, for a lot of reasons but the fundamental reason for its existence seems to us to be strikingly similar to another “currency” and that is gold.

Like BTC, gold is non-denominational (no government controls all of it), it cannot be created out of thin air, it has limited supply and it is universally recognized as a currency of value. Note that Bitcoins have experienced significant corrections before. In August of 2012, BTC dropped 40% in three days. It took four months to recover those losses. From there, BTC went much higher. Even after the recent BTC crash, today BTC is much higher than it was just four months ago. Corrections in bull markets are normal and healthy. Where do bitcoins go from here? As long as its users have faith in it, BTC is likely to continue higher. We believe the same is true for gold.

Thank you for your continued trust and support,

Trevor Holsinger