June 3, 2016

Dear Client,

I am sorry if it seems like I have been incommunicado. I have been extremely busy managing our investments and visiting with you as I make my rounds to discuss 2015's performance. Last year reminded me of the movie that starred Burt Lancaster, *The Birdman of Alcatraz.* Although Lancaster's character did not directly discuss the phenomenon of the canary chirping in a coal mine right before a disaster, the birdman did know about the canary's ability to foretell a future event. Last year's stock market performance was the canary in the coal mine and the general stock market performance as represented by the NYSE Composite was not good. The NYSE was down (-6.4%) last year.

January through March of this year, the broad market was like a repeat of 2008, with the global stock markets going down relentlessly almost every day for two months. I thought to myself, déjà vu all over again. However, I said, "no there is no financial crisis on the horizon, but just a continuance of the correction that started in 2015." And that was the correct path to take because the market quickly recovered. For the most part, our portfolios recovered much of the losses from last year; of course, each portfolio is different and its results will vary.

Going forward, the stock and bond markets will be rocky for the rest of the year as the Federal Reserve may move interest rates higher. Although after Friday's job report, I'm not so sure. But this very fact that the Fed may or may not raise rates advocates a balanced portfolio of stocks and bonds ever more so now than what would have been in the past. The truth of the matter is that no one knows, with certainty, what will occur in the future and to make a large scale bet on any one outcome would be foolish.

In other investment realms, it looks like commercial real estate is extremely overvalued and so is residential real estate, especially in the hot markets of Los Angeles, San Francisco, Miami, and Austin. Yale Economist and Nobel Prize winner, Robert Shiller, is of the opinion that another housing bubble may be starting to form. I would not be surprised since Wells Fargo has now introduced mortgages with as little as 3% down. The Government sponsored FHA and VA will let buyers receive loans with 0% down. Mortgage rates are still cheap. As an investment, most cap rates in real estate are so ridiculously low, it makes no sense. I can see where the roots of a new real estate bubble are starting to form. As the folks who piled into real estate at the top of the 2006 real estate market later discovered, the new ones buying in today will find their own misery.

We are value investors as opposed to those who invest in momentum stocks like Facebook, Google, Tesla, and Amazon. I like more stable companies that are reasonably priced like Archer Daniel Midlands, VCA, and Cardinal Health. I think value stocks do better under periods of uncertainty. And we are certainly in an uncertain period. In fact, uncertainty is always present, but at times, it's higher rather than lower and vice-versa.

If it is true that we are in a "new normal" in which investment returns are low, then a combination of stable stocks, high dividend payers and maybe gold, might be the answer to perform better than the new normal. Some experts project that for the near future, stock returns will produce somewhere between 4% and 6% per annum. Our research colleagues at BCA Research are of the opinion that stock market returns will be around 5% going forward. Their reasoning is this: stock prices are elevated and risk premium for stocks above the interest rates that bonds produce is low. I don't disagree with their assessment.

In this low return and high risk environment I have a couple of weapons to combat that. For one, I have time on my side because I am a long-term minded investor. Most investors think in terms of days or months, but I think in terms of years.

Second, the principles of investment that I learned, first at UCLA and later at Oxford, have served me well over multiple time periods. As Warren Buffett likes to say, “When others are greedy, be fearful and when others are fearful, be greedy.” Since I first read *The Intelligent Investor* by Benjamin Graham over 40 years ago, I have employed a dynamic asset allocation system based on valuation and economic metrics.

When valuations are high and or economic fundamentals are impaired, I reduce stock exposure. When valuations are average or low and economic fundamentals are ok or improving, I increase my equity exposure. Right now, we are approximately 50% exposed to stocks for balanced accounts and 35% exposure in stocks for EFI accounts. I reduced the stock exposure last December. As of today, I feel that this is the proper mix. However, if fundamentals warrant a reduction in equity exposure, I will do so.

A third weapon that I have begun to use against a world of low returns is our new ETS system developed by our colleagues at BCA. Before the year 2000, a portfolio manager like myself could pick some good stocks and add some U.S. Treasury Bills in the mix and produce a great balanced portfolio. It was much simpler back then. However, after the year 2000, it became much more complicated. Since then a good portfolio manager needs to examine the global, macroeconomic environment. We introduced a macroeconomic viewpoint to our analysis beginning in 2001 and we continue to use that viewpoint today. We also have developed and refined approximately 50 variables that I use in stock and bond selections. The problem has always been on how to unify the economic and stock variables in one computer program. We now have done it with the help of BCA. I won’t go into details right now about how it works, but we will be having a live demo at our investment conference. Essentially, the algorithm combines all the variables and ranks stocks in percentiles. For example, if Apple ranks above the 90 percentile, then after thorough analysis, we would buy it, assuming we still liked it after analyzing it. When Apple’s percentile drops below 60, we will sell it. That doesn’t necessarily mean we are buying high and selling low, it just means that the valuation and other metrics have changed. We may be introducing a bit more trading than we have done in the past, but using ETS will help us from giving back our profits like we did with the oil stocks.

Another tool that we use to manage risk is our portfolio protectors. At points in time, I have used gold as a portfolio protector and it proved to be quite successful. Right now, I have purchased Treasury Inflation Protected Securities (TIPS) as part of a portfolio protection plan. My selection of high dividend paying stocks is another way I think we can beat the “new normal” but I cannot assure you of that.

I will be talking about these tools and how I plan on managing the investments going forward. Again, through my blogs and newsletters, it may seem like I was AWOL, but rest assured that I have been spending most of my time meeting with you and managing your investments.

I am looking forward to seeing you at our investment conference at the Balboa bay Club on June 18th. Please RSVP if you haven’t already.

Best regards,

Steven Lee Yamshon
Investment Counsel