January 27, 2016

Dear Client,

Last year was a transition in the global security markets as the U.S. Reserve Bank finally raised interest rates after a 10-year hiatus. When interest rates rise, the markets experience a period of turbulence in most cases. Add a strong U.S. Dollar, competitive currency devaluations, and a broad decline in the commodity complexes, and it is no wonder the markets are having heartburn. Last year, the S&P 500 eked out a small gain of 1.5%. However, if it weren't for the FANG stocks (Facebook, Amazon, Netflix, and Google), the S&P 500 would have been down by more than 7%. How do I know this? Simple, by comparing the similar but broader NYSE Composite Index to the S&P 500. The NYSE composite index was down almost 7%. Bonds were no safe haven either, but certainly more so than stocks. The Barclays Capital Global Bond Index was down 3.3%. Commodities were down. Gold is no safe haven, and China is slowing down.

To understand what is going on in the securities markets, Ms. A comes to our offices twice a year to have lunch with me and discuss these issues. We will be discussing these issues in more detail in a **conference call on February 9th at 6:30 pm (PST).** The instructions on how to dial in this call are at the end of this letter. Here is a transcript of that conversation:

Ms. A: Hello hello, Steve, are you there? I always enjoy coming to sunny California, especially in the wintertime and eat lunch at my favorite restaurant, Bistango. Steve, as you know, I have a considerable amount of money managed by you. As you recall, the previous financial advisor that I had wiped me out in the 2008 financial crisis and I came to you because you had a sensible and diversified approach to investing. It helps me a lot to have you walk me through the extremely complicated economic and financial issues and I like your perspective. I am also relieved that you are sticking to your day job and not becoming a singer - I saw your awful Christmas video. I think the timing of our lunch couldn't be better, considering what is going on in the global financial markets since early December 2015. I find myself increasingly disturbed on what is going on, and with my limited knowledge of economics and finance, I sure would appreciate it if you would talk in simple terms. I know how Oxford trained financial gurus are and they just assume we know all the buzzwords and terminology. I don't. However, I am a good note taker and I jotted down some notes from our last conversation. Last year, you said that you were starting to reduce your risk in stocks and were, on average, reducing your allocation to stocks from 65% to 50% for the traditional value accounts and from 45% to 35% for enhanced fixed income accounts. As you know, I have several accounts in traditional value, enhanced fixed income, and in your fund, YY&R. I also read the paper on the way from England and the geopolitical situation seems out of control. Can you begin your conversation on these topics?

Steve: It was a difficult year that was full of some nasty surprises, which I will get into later; but one thing that didn't surprise me was that a correction was waiting to happen. For one, the current market breadth was extremely poor, with only four or five stocks leading the market. Secondly, easy money comes and easy money goes. When the Federal Reserve Bank reduces liquidity in the system by first stopping Quantitative Easing (QE) and then raising interest rates, the markets are about to go down.

Ms. A: What are you having for lunch?

Steve: The steak sandwich but don't tell Dr. K.

Ms. A: I'm having the salad because I am on a diet. How come you couldn't time the exit out of markets?

Steve: Forecasting relies on past historical data in periods of similarities and then applying those lessons to the present. However, if you read some of my newsletters and blogs, I did mention Charles Kindelberger and his view of the Global Depression from 1932-1937. He wrote that the world economies suffered again in 1937 because the world was experiencing a multi-year commodity price decline, competitive currency devaluations, and a strong U.S. Dollar. Not unlike today. Since the financial crisis in 2008, the moves by the global central banks have been unprecedented. The rules of the game have changed, and a reliable guide to the future is not available. Economist Murray Rothbard wrote that the depression was not caused by the stock market crash but rather by global trade wars, currency imbalances, and higher interest rates.

Ms. A: I don't want to keep working the rest of my life. Should we sell all our stocks and bonds and go to cash now since you said the bond market lost a small amount of money last year and could lose money this year?

Steve: First of all, that is a short-term play and most experienced investors know that this is a loser's game. It is difficult, if not impossible, to completely time the market. How do you know when to get back in? What if a company gets taken over and the stock pops? How would you recoup any loss in a stock?

Ms. A: Is there a better way?

Steve: Yes, Benjamin Graham, Warren Buffet's mentor, laid out the principles of good investment a long time ago.

Ms. A: What is that?

Steve: He said he could never forecast the markets with any precision or extreme accuracy so he gave up trying. He said that a diversified portfolio is the best defense and protection for your portfolio. He further stated in the *Intelligent Investor* that if the stock market was high, you reduce your exposure to stocks, and if the market is low, you increase them, but always have 25% in stocks and 25% in bonds. Right now we are at 50-50. His investing philosophy has served me well for over 35 years and you too.

Ms. A: If I recall, you were approximately 40% in stocks much of the 2000 decade and below that in 2008-2009. Why not reduce to that point now?

Steve: I reduced the positions as I interpreted the data and signals. Right now, the data is telling me we are in a nasty correction but not a bear market, and the right mix is 50/50. However, if I have to, I would reduce the stock allocation to reduce risk exposure. At this moment, bonds look better to me than stocks. With that being said, bonds don't return much as these interest rate levels and interest rates will most likely not go up much. Although we want a good dose of bonds, we don't want all bonds except for those portfolios whose investment mandate is all bonds. Look A, the stock market is expected to have a correction after seven years and it is healthy. A good correction wipes out the morons who are speculating, think that they are masters of the universe, and eventually get burnt. Warren Buffett once said, "Good business practices make good business," and investing in the stock market is the same way. Besides, we tend to perform better in down markets than in markets that shoot straight up. You really liked your salad; I noticed you ordered a second one.

Ms. A: You must have really liked the bread because it is all gone. I wonder what Dr. K would think about all the butter you ate today. Anyways, love, what are your thoughts on going forward?

Steve: Please don't tell Dr. K. I would be in big trouble. I will skip the cheesecake. My dear friend, I don't know exactly how this will play out, but I will tell you that I will be vigilant. If I think the market dynamics will change, then so will I. However, as you know, I am a long-term investor, and I don't trade in and out of the markets with lightning speed. Just because there is a bear market doesn't mean I won't buy selected stocks when there is an opportunity. Just the other day, I bought Yahoo because the "for sale" sign was on the front door. I also like oil.

Ms. A: Oil? Yikes! Why?

Steve: I think the decline in the price is overblown and that oil will recover in the next couple of years. Right now, there is a glut of oil due to many factors, but in time, that will reverse course. I am not adding to my existing oil position right now, but I don't see how you could go wrong with the large integrated oil producers since they pay great dividends. Oil prices are now down to 2003 prices, which seems ridiculous to me. That is what I mean about forecasting. First, the genius forecasters predicted "peak oil" when the price of oil reached $145 per barrel. Now, the same people say oil will be at $20 per barrel for the next fifty years. However, I noticed Warren Buffett buying Phillips 66. That might tell you something. At some point, I may buy one or two more integrated oil companies.

Ms. A: What do you think market returns will be going forward?

Steve: As I have stated earlier, predictions are a horrible business and I don't even like to make any. However, using some tools from my class that I teach at UCLA, I think for the next couple of years, the stock market will return approximately 4% to 5%. I think we can do better, although I cannot guarantee that or even predict it, but it seems to me that by using Graham's principles, buying beaten up stocks, the chance of price appreciation would be better than buying the overvalued FANG stocks.

Ms. A: Steve, I miss seeing you. When are you going back to Oxford?

Steve: Well Ms. A, you know that I go back there four times a year since I learn a lot that helps me manage the securities portfolios. I think I will be back in April. Let's have dinner when I am in London.

Ms. A: In the meantime, are you planning to keep your investors and clients informed on what is going on?

Steve: I am glad you brought that up**. Yes, there is a conference call on Tuesday, February 9th at 6:30 pm (PST),** to discuss some of the issues I had brought up and provide some more clarity and detail. Let me drive you to the airport.

Ms. A: Thanks Steve, and thanks for lunch. The cheesecake was delicious. Don't worry about Dr. K.

Conference Call Instructions:
To access the conference call on **Tuesday, February 9, 2016 at 6:30pm (PST)**, please dial the toll-free number, **1-800-914-8405**. Once prompted, enter the access code: **5486434**, **followed by the # button**. Prior to the conference call, if you have any questions or topics you would like addressed during the call, please email Tiffany at tiffany@sfpria.com, or call us at 949-251-9333.

Best regards,

Steven Lee Yamshon
Investment Counsel