First Quarter 2013 Investor Letter

Portfolio Comments

In Michael Lewis' classic investment book, The Big Short: Inside The Doomsday Machine, Lewis spends a significant portion of the book describing the career of a new hedge fund manager, Michael Burry, whose analysis pointed to a bubble in mortgages in the mid-2000s and led to his investing a large portion of his fund in a short mortgage position during the late stages of the housing boom. His analysis eventually proved to be correct, and when the mortgage market crashed, Burry's fund scored big gains. Burry related in a 2011 *Bloomberg Risk Takers* profile, "I don't go out looking for good shorts. I'm spending my time looking for good longs. I shorted mortgages because I had to. Every bit of logic I had led me to this trade and I had to do it." He stuck to his analysis and convictions even though a number of his fund investors objected and some actually pulled out their money before his predictions came true. According to an April 2010 Vanity Fair article, "he earned a personal profit of $100 million and a profit for his remaining investors of more than $700 million; [his firm,] Scion Capital ultimately recorded returns of 489.34 percent (net of fees and expenses) between its November 1, 2000 inception and June 2008. The S&P 500 returned just over two percent over the same period."

We believe our portfolios are set up in a similar fashion as Burry's hedge fund and will earn outsized returns (Scion's positions were levered, so they took a lot more risk and ended up making much larger gains than unlevered returns generally provide). Central banks providing huge new bank reserves and virtually unlimited credit coupled with historically-large governmental deficit spending has never in history launched an economy into health from a credit-bloated, central bank-intervening, too-big-to-fail, financial-oriented economy we see today.
Historically, people in the United States and other capitalist countries have thrived as risk-takers and some built great enterprises that become cornerstone companies that continue to be successful today. Many others have been unsuccessful, with the stockholders' investments going to zero and the bondholders dividing up the remnants. However, marketplace success/failure and capitalism's creative destruction are not the economic forces that affect large financial institutions and financial markets today. Instead we are in a market dominated by easy central bank monetary policy, an emphasis on high frequency trading and markets pushed around by momentum buying for companies deemed to have growth and momentum selling of those without. In this environment, we have tried to position portfolios for the inevitable hangover that occurs when the US Federal Reserve-induced "party" ends, and the inevitable inflation that always happens when humans have the ability to print money at will.

During the first quarter, trading momentum and the power of the Fed's monetary stimulus powered the US stock market higher as it decoupled from the uneven economic performance that persisted over all three months. Our portfolios are set up to retain value when world economies underperform and the markets reflect this underperformance, but market euphoria and "risk-on" investor sentiment meant our defensive portfolios underperformed again this quarter.

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We increased our exposure to the markets over the quarter by first removing any hedges we had placed in 2012 and increasing our exposure to some industrial, consumer, agricultural and Japanese stocks, all of which did well during the quarter. Our energy and healthcare positions performed well while our metals and mining position underperformed. These stocks underperformed in spite of excellent valuation and favorable economic and political conditions; however, market participants thought there were better "risk-on" positions and did not see these stocks and ETFs as short-term protection when risk was taken off.

Our best performers during most of the quarter were our short yen positions, which benefitted from new Prime Minister Abe's concerted effort to have both the Japanese government and the Japan Central Bank institute larger programs of quantitative easing to overcome the multi-year deflation that has enveloped the Japanese economy. Curiously, the reasons for being short the yen are also reasons for being long precious metals and mining stocks. However, investors were not attracted to them until March when they recovered from February declines. By then, precious metals and mining companies reflected excellent valuations and prospects and the increasing world unease around the unraveling of Cyprus' large banking sector and its effects on the Eurozone and the euro currency.

First Quarter Market Conditions

The markets were ebullient in January as the fiscal deal averting any bad outcomes from the "fiscal cliff" negotiations caused traders to sound the "all-clear" and markets to outperform during January. The S&P 500 gained more than 5%, with healthcare, energy and financial sectors outperforming and telecom and technology underperforming. Bonds were down strongly, nearing the 2% level on the 10-year US Treasury bonds, while oil was up 6% and precious metals were virtually flat.

February was very different, as the S&P 500 was only up fractionally, led by defensive consumer staples, telecoms and utilities. Poor economic reports out of Europe and worries about Asian growth led materials stocks lower, including metals and mining shares, due to the perceived lower demand for materials overseas. Energy, technology and consumer discretionary stocks also underperformed, as oil dropped 5% and precious metals were down 4%. The US dollar and US bonds were beneficiaries, rising as capital fled to the US.

March was a rebalancing – most sectors gained, as materials and energy bounced back from February losses and consumer discretionary and healthcare increased most strongly. Curiously, consumer staples, utilities and bonds, usually more defensive, also performed well in March. Most of the outperformance came in early March; in late March, the markets were more defensive as bonds and staples gained during Europe's turmoil over the failure of Cyprus' banking system and the effects on the euro and European countries' lower-rated bonds.

All-in-all, it was a quarter characterized by easy Fed monetary policy, market momentum and the outperformance of heavily-shorted stocks, many of which rose strongly when the shorts were forced to cover as the market continued to rise (one mid-March study based on Bloomberg data had the most

shorted stocks in the widely-held Russell 3000 outperforming the index by an astounding 12% during the four months). The Dow Jones Industrial Average also outperformed, which with the short-covering, is often associated with aging bull markets. Meanwhile, economic data continued to show deterioration not only in the US and European economies, but even in China and India. This was highlighted by fourth quarter 2012 US GDP initially being reported as negative, although revisions showed the US economy barely growing (by 0.4%).

Precious Metals

Precious metals suffered from being caught between the "risk-on" assets (stocks) and "risk-off" assets (bonds, cash) during the quarter. As stocks surged in January, precious metals and metals stocks were left behind because many investors thought they were "not needed". When stocks weakened during February and some investors sold stocks, the money was put into bonds or left in cash, since many consider gold to be "too volatile". This was the general explanation for underperformance during the quarter, along with having few real crisis moments until March (Europe was again pretty quiet all quarter, with European bonds and stocks rising due to a lack of negative catalysts until mid-March).

However, a number of positive catalysts continued to make gold an attractive alternative. According to a World Gold Council report, central banks continue to be large buyers of physical bullion; 2012 net purchases were 14.8 million ounces, or 535 tonnes, which is 17% more than 2011 and the largest amount bought since 1964 when inflation was heating up due to the "guns and butter" inflationary policies of the Johnson Administration in the mid-1960s. Total demand for gold in the fourth quarter picked up appreciably, with demand in India jumping 41% over 4Q2011 to 262 tonnes, of which 153 tonnes was for jewelry. Chinese demand for gold was up 1% in the fourth quarter to 203 tonnes, of which 137 tonnes were for jewelry and 66 tonnes for investment demand.

For the quarter, Gold lost 4.8%, closing at $1,595.70/oz. Silver lost 6.8% to close at $28.29/oz. Gold and silver mining equities continued their slide until early March when gold and silver began to look like they were establishing a short-term bottom. The continued downward pressure in the miners has led them to trade at historically low valuations in respect to the price of the metals themselves and in relation to the price of the overall stock market.

Energy

Energy prices were up during the quarter, reflecting the colder-than-normal winter in the northern hemisphere and the continued (albeit slower) economic growth in Asia. The strength of crude oil prices surprised many market participants, because many thought that slowing world economies would take their toll on oil prices. However Asian economic growth and the inability for large amounts of newly discovered and produced shale oil from the American Midwest to get to world markets kept price high. Japan's continued disuse of its nuclear power plants continued to underpin Asian demand, as the cold winter caused more oil and LNG to be shipped to Japan, causing it to have current account deficits during the quarter. West Texas Intermediate crude oil prices rose 5.3% during the quarter to close at $96.65, reflecting US energy usage and growth in products exported to the rest of the world. US natural gas prices rose strongly (up 19.4% during the quarter) as the US winter

weather was unseasonably cold throughout early 2013. Prices ended March at $4.01/MMBtu, above $4/MMBtu for the first time since September 2011.

Bonds

Bond prices weakened during much of the quarter as investors anticipated world growth in January and part of February. Conversely, uneven economic statistics coupled with worsening European economies and worry about Asian growth slowdowns led to higher bond prices (and lower yields) in late February and March. The 10-year Treasury rate vacillated between 1.76% at the start of the year and 2.09% in early March before closing at 1.85% for the quarter.

Other Markets

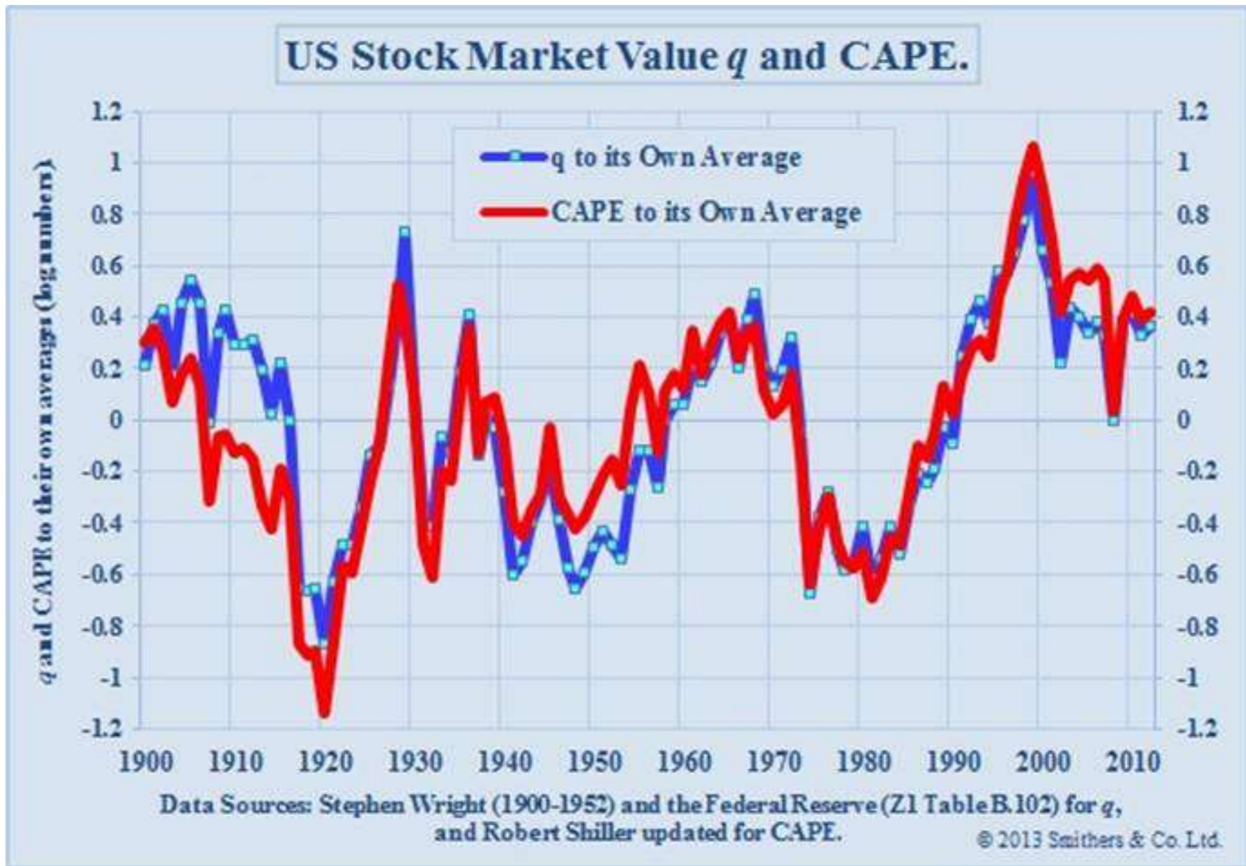
Many international equity markets were higher during the quarter, led by smaller European and Asian markets. However, both Chinese and Indian markets were notable underperformers, falling 3.3% and 5.5% respectively.. Southern and eastern European markets were some of the worst performers, with the Ukraine falling 16%, Czech Republic 9.6%, and Greece down 7.1%. "Problem children" Italy (down 4.7%), Spain (down 2.8%) and Cyprus (down 14.2%) were all weaker, which pulled the euro down versus the dollar 2.6% during the quarter. Japan was the major country with an outperforming stock market, up 21.0% in yen terms but still up 11.3% in US dollars. Thus, US markets attracted more capital and outperformed, while growth concerns (Asia ex-Japan) and political and economic worries (much of Europe) drove underperformance much of the rest of the world.

Going Forward

The crosscurrents of the weak recent US and European economic reports coupled with enthusiastic support of the US stock market while worldwide bond market yields continue to drop all add up to a confusing market environment. The majority of Wall Street strategists, institutional money managers and traders are bullish as measured by various sentiment measures, but there are a number of worrying factors emerging that we believe could short-circuit the stock market's recent advances. First, governmental stimulus programs seem to more and more resemble policies that led to many of the recent problems in the first place: in an April 2, 2013 article in The Washington Post titled "Obama Administration Pushes Banks to Make Home Loans to People with Weaker Credit," author Zachary Goldfarb says officials say that banks should "use more subjective judgement in determining whether to offer a loan" and the Justice Department should "provide assurances to banks … that they will not face legal or financial recriminations if they make loans to riskier borrowers." Meanwhile, employment has been growing slower than most expected while the widely-followed Purchasing Managers Indices have been falling in the past couple of months, heralding slower growth in the future. Through these prisms we will examine various investment options.

Equities

Stock market bullish sentiment approached 50% according to surveys taken in late March, while bearish sentiment dropped below 20%; these are relatively extreme values and reflect the near constant rise of US stock markets since November 2012. At the same time, **corporate profit margins are approximately 70% above historical norms**, reflecting relatively low labor costs (due to high supply of labor), low capital costs (interest rates at or near historical lows) and recent moderating input costs (downswings in commodity prices). These are great statistics to explain the recent rise in stock prices, but they have historically been unsustainable and lead to lower future returns. John Hussman, portfolio manager of the Hussman Funds and former finance professor, writes in a recent commentary entitled *Investment, Speculation, Valuation and Tinker Bell* that “[t]he last time bearish sentiment was below 20%, [the market was] at a 4-year market high and [the 10-year average market P/E] multiple was above 18 (S&P 500 divided by the 10-year average inflation-adjusted earnings – the present multiple is 23) was [in] May 2007. Other prior instances of these conditions occurred in August 1987 (high just before the Crash of ’87), in December 1972/January 1973 (just before the big market correction in 1973/1974, and in February 1966 (just before the mid-1960s high in the stock market). Thus, Hussman shows that the market seems to be extremely overvalued from a historical perspective. Hussman cites another valuation measure called “Tobin’s q” which matches market values versus replacement values. He quotes Andrew Smithers, a London-based analyst that has calculated Tobin’s q for a number of years – its current reading, with the S&P 500 around 1550, is an overvaluation of 65%! The past accuracy of using the Tobin’s q calculations are chronicled by Hussman in his April 1, 2013 commentary titled *We Should Have Already Learned How This Will End*:



> Notice that in 1982, the -0.7 reading on Smithers' log-scale chart implied that stocks were undervalued by exp(-0.7)-1 = -50%. At that point, with the dividend yield on the S&P 500 about 6.7%, **one would have estimated a 10-year prospective total return for the S&P 500 of 1.063*(1/0.5)^(1/10)+.067 – 1 = 20.6% annually. One would have been correct.** ***[Emphasis ours – KS]***
>
> In contrast, note that in 2000, the 1.0 reading implied that stocks were overvalued by exp(1.0)-1 = 172%. At that point, with the dividend yield on the S&P 500 at just 1.2%, **one would have estimated a 10-year prospective total return for the S&P 500 of 1.063*(1/2.72)^(1/10)+.012 = -2.6% annually. Again, one would have been correct.** ***[Emphasis ours – KS]***

The Fed's pumping more and more money into the US banks' accounts has led to financial markets rising since November 2012; however, the markets and US economy are starting to appear "tired". We believe there will be a retrenchment by mid-summer as weakening economic conditions worldwide take their toll on corporate profits (40+% of US corporate profits are generated internationally).

Precious Metals

Here are some quotes and headlines that appear to characterize recent weakness in the precious metals markets:

> "For the moment at least, the party seems to be over" *New York Times*
>
> "'It's a seller's market. No one is buying gold,' a dealer in Zurich said." *New York Times*
>
> "…The dollar is steady, world inflation rates have come down, and the general panic set off by the oil crisis has abated. All those trends reduce the distrust of paper money that moves many speculators to put their funds in gold." *Time Magazine*
>
> "Currently [gold analyst] Mr. LaLoggia has this to say: 'There is simply nothing in the economic picture today to cause a rush into gold. The technical damage caused by the decline is enormous and it cannot be erased quickly. Avoid gold and gold stocks.'" *New York Times*

These are all quotes from 1976, as compiled by Jeff Clark of Casey Research in his mid-march commentary *Gold is Over – Just Like in 1976*. Clark describes how some central bank selling and some strength in the economy in 1976 had driven down gold from a recent high near $200/oz to $104/oz – a 47% decline in the price over a 20-month period. This compares to a recent 26% loss in gold since September 2011, a 19-month period, while fundamentals for higher prices have never been more favorable.

The 1970s gold story is well-known: from its September 1976 low of $104/oz, gold went up for a number of years, culminating with an exponential rise to $850/oz in 1980. Much of the rise occurred when conditions were far less favorable than today – the Paul Volcker-led Federal Reserve had started to severely tighten interest rates but gold rose anyway as inflation expectations drove buying of all inflation shelters. Today, the Fed is encouraging inflation, fearing deflation and pumping reserves into the banking system at previously-unimaginable rates. In addition, in spite of the recent sequestration of federal outlays, the yearly deficit is still expected to approach $1 trillion again this fiscal year, meaning the US government will incur even more debt that it can only eventually pay back with depreciated dollars, which of course will have to be produced through even more printing by the Fed.

Another support to the fundamentals of owning precious metals is the announcement by the Germans that they would be repatriating a lot of the gold which is held by other central banks overseas. In February, the Bundesbank [Germany's central bank] surprised the financial world when it announced it would be moving all its gold stored in Paris and a large percentage of its New York bullion to its Frankfurt vaults. This was said to be done for internal political reasons, but the Germans' move to safeguard half of their large gold hoard (the second largest disclosed holding in the world after the US) was mostly interpreted as the Bundesbank not completely trusting their ability to control their gold reserves stored outside the country. If the Germans don't trust the French and the US Fed, maybe investors should reassess their complacency toward not holding some physical bullion personally. As this bullion is moved from current locations, we believe that it will influence the availability of physical gold, producing upward price pressure. [The Fed has historically lent gold to

gold dealers in order for them to sell it into the physical market. Eventually these "gold loans" must be paid back; with less gold in the Fed's vaults after the German repatriation of some of its gold, there will be less gold to be lent out by the Fed, leading to more pressure to buy gold to repay gold loans.] In addition to the German announcement, a coalition of Swiss citizens has gathered enough signatures for a national referendum in Switzerland to limit the Swiss Bank [Switzerland's central bank] from selling or lending its gold reserves. Thus, this movement to limit gold sales and loans may be spreading worldwide.

Another bullish element to the precious metals markets is insider buying of stock at gold mining companies. Insider buying ramped up during the first quarter as prospects brightened due to low stock prices, new management teams at a number of companies and improving cost containment initiatives. According to INK Research, seven times as many precious metals mining companies on the Toronto Stock Exchange had insider buying compared to insider sales during the quarter. According to the CEO of INK, this is the type of buying last seen during the height of the 2008/2009 financial crises when these mining companies fell with other stocks but recovered much faster than most other sectors.

And valuations are compelling at precious metals mining companies. Gold Stock Analyst, which does extensive research on gold and silver mining stocks, has a number of valuation methods that show that **gold mining stocks are actually even cheaper than they were in 2008**. By their measure, GSA estimated that their large coverage of gold stocks were ~35% undervalued for the prevailing gold price in March and April 2013, and with the mid-April price drop, valuations are even lower.

Finally, Paul Singer of Elliott Management ($22 billion of hedge fund assets under management and often described as "one of the smartest guys on Wall Street") is a holder of gold investments in his funds, and he recently had this to say about gold:

> "The world is on a seemingly one-way trip to monetary debasement as the catchall economic policy, and there is only one store of value and medium of exchange that has stood the test of time as "real money": gold. We expect this dynamic to assert itself in a large way at some point. In the meantime, it is quite frustrating to watch the price of gold fall as the conditions that should cause it to appreciate seem more and more prevalent.
>
> Gold may not exactly be a "safe haven" in the sense of an asset whose value is precisely known and stable. But it surely is an asset that, in a particular set of circumstances, becomes a unique and irreplaceable "must-have." In those circumstances (loss of confidence in governments and paper money), there are no substitutes, and the price of gold may reflect that characteristic at some point."

In mid-April, weak market technicals combined with downward price momentum and a scare that financially weak European countries could be forced to sell their central banks' gold reserves drove gold prices down 15% in two days, bottoming at approximately $1,320 on April 15th and again on April 18th. This price action was reminiscent of other market bottoms where panic forced many weak holders to sell and volumes traded were immense. Prices have recovered strongly at the time

of writing (over $100 higher), underpinned by huge worldwide buying of physical gold and silver (physical purchases in India, China, even Canada and the US are at levels not seen in decades, according to numerous news reports). We believe that this washout has marked the market bottom, due to the unbelievably negative sentiment ["everyone is bearish"], the "crowded" nature of the short gold trade ["a large amount of funds are short gold"] and the extreme undervaluation of the gold mining stock compared to their historical valuation ranges. While we cannot predict when prices will recover to late March price levels, we believe that precious metals and mining companies have entered a new bull market that will take all elements to new highs. The tendency for central banks to continue their easing programs (or increase them, as we believe will happen) is the underpinning for this call.

Energy

We have been less bullish about energy, expecting that oil prices could weaken in the short run due to weakening world economies. We have maintained positions in undervalued oil producers because we believe that world population growth, continued economic expansion (even if at a slower pace) in Asia, and the exhaustion of low cost oil production would lead to higher oil prices over time. By investing in large but out-of-favor companies that pay good dividends, we believe that we can "hide out" in good companies until the valuation of their long-lived reserves are realized. US oil from the shale revolution, while plentiful, is expensive to produce and is still restricted by logistical bottlenecks from reaching world markets in size. Meanwhile, super-giant legacy fields around the world continue to deplete. We believe companies with long-lived reserves will have a revaluation of those reserves as the cost of finding oil continues to rise.

We have de-emphasized North American natural gas in the portfolio over the past couple of years due to our fear of oversupply due to the shale revolution in gas. While prices have risen over $4/MMBtu this spring due to continued cold spring weather, we still believe that there are large amounts of already drilled reserves that can be brought on-stream in relatively short order, capping prices for months or even another year. Only when natgas supply/demand dynamics show regular seasonality in the fall will we start to believe that available supply has come down near demand levels at attractive prices.

Coal companies have performed miserably over the past couple of years as cheap natural gas has replaced coal in power generation due to its more attractive environmental characteristics. The coal companies' valuations look like some companies are on the verge of bankruptcy. If natural gas prices can hold these levels (or rise in price), coal companies may be a good investment as coal prices will rise with higher natural gas prices.

Other Markets

The bond markets were expected in the financial press to continue to weaken in 2013 as economies around the world slowly improved and the "great rotation" was expected to see fund managers sell incremental bond holdings and rotate into stocks. This prediction has not happened, as fund flows into bonds have continued to exceed flows into stocks. However, bonds continue to look unattractive

to us due to negative real interest rates (interest rates less than the rate of inflation). This means investments in bonds will lose purchasing power if inflation stays at current levels or increases. Bond bulls look at stocks and see overvaluation, arguing that losing a small percentage of purchasing power can be overcome by capital gains of owning bonds, and this is a lot less risky than overpriced stocks. We believe that if there is a "Black Swan" in the US financial system, it will be the unexpected rise in interest rates – while there are some that believe it will happen, institutional money managers (as a group) continue to hold large amounts of fixed income and are adding to their holdings – a definitive vote against higher rates anytime soon.

The easing campaign in Japan will affect world financial markets in a number of ways. We believe Japanese stocks will benefit, at least for a time, and it seems like Japanese bonds will benefit from Bank of Japan purchases initially. However, a falling yen and rising inflation could push bond prices down and yields up for Japanese government bonds (JGBs) after the initial "front-running the central bank buying spree" plays out.

A lower yen will also affect currencies around the world. "Dollars" generically should be the winners: US dollars will be bought by investors worldwide because US dollars are still considered safe havens. However, we believe Canadian dollars, Australian dollars and even New Zealand dollars will also be places where worldwide capital flows due to their relatively stable economies, central bank policies and hard asset-based economics.

The weaker yen will also have a greater influence on trade over time. With the yen lower (and we expect it to fall further), Japanese products will become far more competitive in world markets, crowding out exports from Germany, South Korea and the United States. Since Japanese policies are supported heartily by the Japanese populace and have been "blessed" by the finance ministers of the G-20 during its April 2013 meeting, we think Japan will move to make exports cheaper and imports more expensive by an even weaker yen, and one result will be that German exports will suffer. This will probably lead to even more pressure on the ECB to weaken the euro, and lead to the South Koreans (and other Asian countries) to weaken their currencies, further accelerating what many have dubbed a "currency war." We also believe the US Fed will at some point raise their QE amounts, to help "avoid deflation and keep inflation near its 2% target" which should also lead to some US dollar weakness, helping US exports to stay competitive. Under this scenario of mounting currency movements, we believe we should own stocks in countries with stronger (or at least stable) currencies that produce essential products and services as well as owning companies with resources in the ground.

Cyprus

The island of Cyprus burst onto the world stage during March 2013 as its banks became such a problem that a financial rescue became imperative. Cyprus is a member of the European Union (having joined in 2004) and is also a member of the Economic and Monetary Union (EMU), which means that they use the euro as their currency. Being a small, relatively low-productivity country, they turned to tourism and finance as ways to attract capital and generate economic activity. The Cypriots succeeded, primarily attracting British (the former administrator for almost 100 years before

Cypriot independence in 1960) and Russian capital and economic projects. Cyprus was a great place for Russians due to its EU membership, lax banking rules (allowing for illicit deposits and money-laundering activity), and its location outside of the bottled-up Black Sea and Mediterranean climate. Culturally, the island is divided by a Greek-dominated southern half and a Turkish-dominated northern section.

The problems started when huge amounts of Russian cash were deposited in Cypriot banks. A lot of this capital was lent into the Greek and Turkish bond markets for residential and commercial real estate. In addition, the banks bought large amounts of Greek government debt, since it was EU debt (thought to be "safe") with attractive yields. As the Greek economic situation deteriorated, Greece eventually required a bailout and its bonds were "haircut." The Cypriot banks took large losses and became a huge problem for the economy because the banking sector was approximately 9 times as large as the rest of the Cypriot economy! Thus, the banks were about to fail due to their Greek bond losses, and the economy would then go into depression without a bailout. So Cyprus went to the EU for a bailout – just like Greece and Portugal (and to a lesser extent Spain) had done in the recent past.

However, instead of getting a deal similar to Greece, the EU, European Central Bank (ECB) and the International Monetary Fund (IMF), together known as "the Troika", imposed a much different solution to their €10 billion banking problem. Colored by the existence of Russian deposits (thought to be mostly Russian mob money being laundered, Russian oligarch money or Russian government officials' bribery money), the Troika demanded that for Cyprus to get bailout loans, part of the €10 billion problem would have to come from "taxes on deposits", a euphemism for seizing depository money in addition to wiping out banks' bondholders and stockholders holdings. Initially, even smaller deposits, heretofore thought to be protected by depositors insurance (similar to US FDIC deposit insurance), were to lose 6.75% of their money, with larger depositors (above 100,000 euros in the account) to lose 9.9%. The outrage by small depositors caused this solution to be voted down by Cyprus' Parliament, but after small depositors were excluded from "taxes", the Cypriot government recently agreed to assistance from the Troika in return for losses by depositors with accounts over €100,000. Amazingly, the details of the bailout are still to be worked out – trying to get "the numbers to work". What is known is: 1) that capital controls have been imposed, 2) only small withdrawals from banks are allowed and 3) only very small amounts of cash are allowed to leave the country. Following the imposition of these rules, it emerged that vast amounts of the "large deposits" were withdrawn prior to the capital controls being imposed, with €2.2 billion withdrawn in January and February (according to ECB records) and a large amount were withdrawn just prior to the breakout of the crisis. The crisis has since grown to €23 billion due to the withdrawals of cash before (and even during) bailout negotiations – large amounts of the money were withdrawn from the London branches of Cypriot banks!

The importance of the Cyprus situation is multifold: 1) While Europeans see Cyprus as a sideshow, mostly because of its size, it is a full-fledged member of the EU and EMU, and its treatment acts as a precedent, regardless of what EU officials claim. It will probably be forced to leave the EU/EMU (due to the decimation of its economy resulting from Russian departures and destroyed financial sector), becoming the first country to do so and establishing more precedents. 2) The Cypriot situation shows the actions of the Troika when backed into a corner politically – instead of

being the benevolent bailout source, it becomes the judge and jury and can appropriate citizens' bank deposits to settle the debts of others (in this and other cases, the country's banks). And most at risk is the big money – the deposits larger than those protected by deposit insurance, which also happens to be the most attractive kind of deposits for banks. 3) The European decision-makers drastically underestimated the role of confidence in their plans for the resolution of Cyprus' financial problems. Confidence in EU leadership and safety of capital in Europe has been permanently called into question. In the future, Europe in aggregate will be losing banking deposits as capital owners rightly fear for the safety of their cash. The winners will be havens which people believe better respect private property and have less-volatile currency values: the United States (although some actions in recent years would make the US less safe than previously thought), Canada, Australia and, of course, ***gold.*** The other loser will be the euro, because the treatment of Cyprus will be thought to be the way money could be treated throughout the Eurozone, regardless of what country you are in – Italy, Spain, Portugal, Ireland, etc.

Kanos Quarterly Commentary

Interview With The Portfolio Manager

We are asked a lot of financial questions when we talk to our investors and others in our community. We thought it would be helpful to you to present some of those questions in an interview format to give you even better insight into how we think about the financial world and how we manage your portfolio. So, let the games begin:

Question: Why don't we start with philosophy - why do you concentrate on the long-term and not the short-term?

Kirby Shanks: We believe that we can identify medium-to-long-term trends that will make us money for a number of years. By concentrating on the long-term, we can build positions in investments over time, modifying our investments where needed, and keep those positions until we believe the trend has essentially ended. Besides being tax efficient, buying and holding long-term positions means we have to make fewer "good calls" about when to get out and then back in during weakness. Of course, it also exposes our portfolios to much more volatility.

Question: What shapes your long-term philosophy right now? What might change it?

Kirby Shanks: While this is a complex question, we think we can distill things down to a short answer. The buildup of debt over time and the subsequent "market upsets" that we've been experiencing since the late 1990s have thrust central banks to the forefront of financial markets. Let's be frank here, they are managing the markets to try to achieve the "pre-crash financial status quo" in an increasingly unstable world. We are trying to position portfolios to

defend against the inevitable consequences of unstable markets. Central banks' main "tool" to manage markets has been increased liquidity, aka "printing money" (or more properly, adding reserves to bank balance sheets). <u>In history, increasing the money supply has ALWAYS led to inflation, and creating so much new money has led to a lot of inflation</u>. While bank reserves have only fed into the economy slowly, registering as only "low" inflation, such large reservoirs of money in banks has led to higher prices in almost everything but labor. Thus, we believe we have plenty of non-labor inflation, and we are trying to defend your portfolios against this and more classical inflation while trying to generate income in a low-yield, slow-growth world economy.

Importantly, what might change our investment stance would be a large, sustained change in central banks' behavior and credible reduction in debt and future obligations (social security/public pensions, public health care, etc.), especially if those new policies were correctly constructed to enhance economic growth. Right now, much of the world is growing its debt and future obligations at a higher rate than economies are growing. The current amount of debt and obligations to be serviced are <u>already too high for our economy to support.</u> Once economies start to live closer to their means, then our philosophy can change.

<u>Question</u>: Why did you refrain from buying solid blue-chip stocks when they hit record lows after the stock market crash in 2008/2009? Didn't some blue chips have a lot of value in their brands, business models, undervalued real estate, etc.?

Kirby Shanks: We were tempted to buy some of the Dow stocks during 2008, but with the virtual "stop" in the economy in the winter of 2008/2009, we were unprepared to put more than token investments into high "relative value" stocks with so many problems still to be solved at the time. One main problem was the wipe-out in residential real estate made a typical US consumer less able to consume going forward, which was being recognized by the 40+% drop in many blue chip stocks. Also a large concern was the insolvency of large US banks; the government (through TARP loans) and the Fed (through emergency loans) solved the <u>illiquidity problem of the banks, but the banks were insolvent, where there liabilities (fixed) were larger than their assets (loans that were dropping in value).</u> We missed that the market would ignore this insolvency and believe the Fed's "stress tests" which judged the banks healthy once they raised some equity capital, which they did – however, this was really a "kabuki" moment. The banks were insolvent and the market just decided to ignore it even though it was very plainly so. During the Great Depression, the US stock market dropped 90% in 1931-32 after a market shock similar to 2007/2008/2009, <u>so we were trying to be defensive and not have our portfolios drop another 50%.</u> Finally, we are very surprised that US consumers have been able to spend the amount they have in the face of their incomes being stagnant in the last five years with prices of so many goods rising – we believe that it has been people using up their financial reserves/savings until "things return to normal". However, the US has experienced the poorest post-recession recovery in the post-World War II period, so our next recession could be very bad when the nation's population has not been able to rebuild their financial situations to the extent they did in prior recoveries.

Question: Why didn't you invest in financial companies after they were bailed out by the government and the Federal Reserve?

Kirby Shanks: As mentioned above, the large banks had large problem loan portfolios that looked obviously insolvent. The policies by the US Government and Federal Reserve allowed the banks to borrow from both the government (TARP) and the Fed, which allowed them to have enough cash to operate. However, this did not mean that these companies were good investments – they had lent recklessly to homeowners and retained huge amounts of that debt on their balance sheets (remember Bear Stearns and Lehman Brothers both went bankrupt doing the same thing as the other large banks; they just did not have large deposit bases like Bank of America or Citigroup which allowed them to have longer-term liquidity). The Fed has done all it could to help its owners, these large banks [that's right – the banks own the Federal Reserve, not the US Government], by lowering interest rates to 0% and then buying bonds (the 4+ rounds of quantitative easing) to give them even more profits. But we keep asking ourselves, if these banks are such good businesses (and their stocks have admittedly soared from their 2009 levels), why does the Fed still have to inject $85 billion per month of liquidity into the financial system? We believe there are still large portfolios of loans in many of these large banks (like all the second mortgages which are literally worthless but could not be written off quickly or would wipe out all a bank's equity). We did invest many portfolios in large Canadian banks, which survived 2008/2009 admirably, but with Canada having experienced a property bubble that is now starting to deflate, we sold those financials, afraid they would have to reveal worsening loan portfolios that would hurt stock prices. Finally, financial regulators have tightened lending standards post-2009 to try to prevent future bad loans. Thus, the ability for smaller banks to make "bread and butter" mortgage and commercial/industrial loans is still impaired, making us hesitant to invest in them. Banks are buying Treasuries and other bonds and financing them in the money markets. While in the short-term this allows them to make a spread between the two, those profits would shrink or disappear if those bonds dropped in value (the US 10-year Treasury is still near all-time lows in yield or highs in price).

Question: We made money in in the past in natural resource-oriented positions, but lately those have underperformed; what have you done to diversify into better performing positions?

Kirby Shanks: The stock market has never had such extreme financial conditions in place for such a long time – zero interest rates followed closely by multiple rounds of quantitative easing. Injections of cash into the financial system have ALWAYS in the past led to future inflation. This is actually the Fed's aim – cause more inflation that will cause prices to rise, leading people to buy future-planned purchases today to avoid higher prices, which will then lead to more economic activity, which will then allow the Fed to withdraw its monetary support. So far, the poor financial conditions of the US post-2008/2009, exacerbated by the crisis of southern European countries' economies (the "PIIGS" which required European bailouts of Portugal, Ireland, Greece and lately Cyprus) continue to lead to a large amount of financial capital fearing deflation. The effects of the deepening European recession, coupled with the slowdown of Asian economies and the stagnation of the US economy, continue to push bonds to higher prices (and lower yields) as investors scramble for yield. <u>These low bond and cash yields</u>

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<u>still signal a deflationary fear in financial markets.</u> With this deflationary fear, equity investors have been paying for any kind of growth (to overcome deflationary forces) and shunning more cyclical stocks like resource companies (believing they need economic growth to grow profitability). Thus, stocks in the US have been rising because the Fed is injecting $85 billion per month into a financial system with little yield – they are the best alternatives in a grim world economic situation – and they often provide current yield. Stocks without large yields have only been driven higher if the markets think the stocks have growth – but these growth stocks now have very high valuations. Thus, we have invested in more attractively-valued, recession-resistant companies in the discount retailing, tobacco, pharmaceutical and basic industry sectors. We have also heavily invested in the events in Japan.

<u>Question</u>: Japan? Why are you taking larger positions in Japan?

Kirby Shanks: Japan may be a precursor to what could happen in the United States. Japan has been mired for almost two decades in a moribund slow-growth economic environment with deflation keeping prices static. While the Japanese have decried their economy growing so little, world investors have parked cash in Japanese yen as Europe has become unglued – leading to a very strong yen, which caused the Japanese economy, dependent on exports, to weaken further. Add to that higher fuel costs with the shuttering of their nuclear plants post-the Fukushima earthquake/tsunami, and the Japanese economy is in a severe recession. Promising to fix the economy by causing inflation, which will lower the yen and make Japanese exports more competitive thereby reviving the Japanese economy, Shinzo Abe won a December 2012 landslide election and swept to power. We followed his ascent and policies closely and have bought exchange traded funds (ETFs) that benefit from a weaker yen. Those investments have greatly benefited our portfolios so far this year. In addition, Abe promised that he would appoint Bank of Japan (their central bank, analogous to our Federal Reserve) governors who would promote easy monetary policy in order to stimulate economic growth. Thus, we have also invested in Japanese stocks through ETFs, but in ETFs that remove the currency depreciation of the yen, thus allowing us to realize the stock gains but not the currency losses of US investors in Japanese stocks. These ETFs are proving to be winners too, especially when the Bank of Japan announced their own version of our Fed's $85 billion per month quantitative easing in which they will provide the equivalent of $70 billion per month of quantitative easing, buying not only Japanese bonds but also real estate investment trusts, ETFs and possibly other financial assets (eventually including stocks?). These moves by the government and central bank have allowed us to realize gains in these positions, and they are just getting started in Japan. We believe there are years of gains to be realized via these investments.

<u>Question</u>: Why do you think we've seen the stock market outperform in the last few months?

Kirby Shanks: The stock market appears to be responding to a few factors, many of which have combined to move the major averages higher, achieving all-time highs (except the Nasdaq). First, and most importantly, central banks have moved to "over-liquefy" economies around the

world, providing never-before-seen amounts of bank reserves and credit to try to eliminate banking concerns and financing constraints; some of this "fire hose" of liquidity has found its way into the financial markets and driven stocks higher. Second, central bank programs have driven bond rates to very low levels; thus, investors have turned to the stock market for yield: dividend rates are higher than bond yields in many cases – this has happened only very rarely since the 1950s. Third, the US government has been in gridlock, and the stock markets like when the government can do little harm. Fourth, abnormally low interest rates and an abundance of labor have allowed corporate America to achieve historically high profit margins – so slow growth in earnings is overcome by high profit margins. Fifth, overseas investors, especially Europeans, are looking for alternative places to invest. The USA's better economic environment denominated in a better currency has attracted a lot of international investment – the dollar has risen 12% since it's recent lows in August 2011 after the debt ceiling "crisis" and the US Government's loss of its AAA credit rating. Finally, momentum and "market gaming" have fallen to the bullish side lately in spite of relatively poor economic data; momentum trading by computers makes up the majority of trading these days and trends tend to feed on themselves – so growth stocks have done well and natural resource stocks have done poorly, continuing the theme referenced above that equity investors still have a deflationary bias. All of these factors, most of which are unsustainable, have propelled the US stock markets higher. How long they continue to do so is the unknowable piece of the puzzle.

Question: Why do you think we've seen bonds continue to outperform in the last few months?

Kirby Shanks: Bonds have continued to be strong (although not at the highs seen last summer) because of a couple of main factors: first, US Federal Reserve policy has kept short-term rates near zero, pulling down the interest rate curve to near historically-low rates for all maturities. Second, to keep long rates even lower than the market might price, the Fed is buying $85 billion per month in longer-term Treasury and US Government agency mortgage-backed bonds, thus pushing up the prices (and pushing down the yields) of those bonds. This central bank manipulation has kept US rates low (and is also being done in England, Japan and to an extent (in different forms) by the European Central Bank and the Swiss National Bank). Third, investors are still unsure of the ability for world economies to grow healthily without central bank support. Therefore, there is a large amount of capital still in bonds for financial stability and safety. Finally, people and especially pension funds still need yield, any kind of yield. Pension funds, retirement plans and annuities must pay out monthly and/or quarterly, and the managers of these portfolios must keep capital in stable assets that pay – thus, they feel that they must keep a large allocation to bonds. These last two reasons have been financial management doctrine for centuries; however, central bank interventions have never been as large as they are today. It will be very interesting to see how these decisions play out going forward.

Question: Has the underperformance of our portfolio companies hurt the companies' values, earnings or prospects?

Kirby Shanks: **While poor stock market performance caused by being "out of favor" can steer capital away from industries, it also tends to instill more discipline into those industries as large holders put pressure on companies to improve their financial performance and, thus, their stock performance. We believe (in the case of our precious metals mining company investments) the underperformance has forced change for the better. A number of management teams have been replaced due to underperformance (including those at the two largest North American miners, Barrick Gold and Newmont Mining). In general, the industry has moved from a growth mode (at any cost) to a "make better economic decisions" mode in the current (depressed) environment, concentrating on lower costs and returning capital to shareholders. Thus, the companies are getting "leaner and meaner" while the low valuations have made the investments extremely attractive as well as high yielding when compared to many other US stocks. Thus, I do not think our companies have been permanently hurt by the downturn. If I think any of them are, we will immediately sell them to redeploy your capital into a more attractive opportunity. As an example, Cisco Systems was briefly the largest company (by market capitalization) on the globe in 2000 when the stock topped $80 per share with an astronomical P/E ratio for such a large company. Last year the stock traded as low as $15 per share, even though revenue and profits are far higher than they were in 2000. In this case, the outlook for Cisco is slow growth at decent but shrinking margins – the stock will never regain the value that it had in the 1990s through 2000. <u>I think our investments are bottoming in their valuations and will be worth far more in the future – history is on our side as gold mining stocks rose hundreds of percent in both the 1930s (as the US Government and Fed tried to manufacture inflation) and in the 1970s (when inflation built from "manageable" levels in the 1960s to "out of control" starting with the Arab oil shock in 1973 and erupting further from there).</u>**

Question: What do you think is going to happen in the US stock market going forward?

Kirby Shanks: **We are big believers that the markets, no matter what factors influence them in the short-term, eventually move to reflect the underlying fundamentals. We believe so strongly in this because it is a natural product of our human nature – at different times, different emotions rule. Right now, it seems like greed has the upper hand. Worldwide central banks have done a good job convincing markets that nothing bad can happen for long. When the stock market buying eventually gets exhausted, the markets will drop and fear will trump greed. This is just another way to express "reversion to the mean" – a widely followed concept on Wall Street that things that move strongly in one direction will eventually reverse and head in the other direction.**

So, with all that in mind, we believe that the US stock markets will eventually exhaust themselves and not rise like they have done in a nearly continuous fashion since March 2009. This bull phase has lasted four years, which is long for a bull market run. It could continue, albeit at a moderate pace, if the Fed continues its quantitative easing. However, we think the Fed has done a very good job of "stoking the inflationary fire", and with so many new dollars having been produced, hard assets, especially ones that produce cash flow, will be the big winners for the next few years. However, momentum trading, accompanied by the volatility

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we've seen over the past few quarters will probably characterize the markets until a catalyst appears to change those dynamics.

Question: What has surprised you about financial markets over the past few months and years?

Kirby Shanks: A couple of things still surprise us in the markets today: first, the prevalence of excitement surrounding technology companies, even after the debacle of 2000-2003 and the huge drop of 2008-2009. In spite of large down moves in many stocks, the market still seems fascinated by the potential for growth in some of these companies and values them at valuations that are plainly unsustainable. In spite of Apple's ascent and subsequent fall, other companies like Amazon and Salesforce.com still sport current losses and forward P/E ratios of over 60x! The valuation multiples of such large companies continue to surprise us. The other thing that continues to shock us is the lack of respect for history, specifically with regard to the huge debts our country, companies and individuals are running up and the egregious money creation that is being used to support it. We are surprised that people think things are "business as usual" and that these measures will be used to "get us out of this mess" and soon the country and financial markets will be "cured". Debts in excess of 100% of GDP, with total liabilities that are many times larger, being supported by the central bank creating more and more money out of thin air are signs of an economy destined for a debt crack-up. However, financial markets are reacting as if 2008-2009 showed that everyone can sell everything and "go to bonds and cash" to protect themselves. The ability to add liquidity to buy time for financial healing and time for the government to spend far above its means to maintain economic stability are emergency measures that the authorities are using now on an ongoing basis – when the next crisis hits, what measures will they have to use? Just more and more liquidity creation and larger amounts of government deficit spending? We cringe thinking about the irresponsibility and lack of planning in Washington DC.

Question: Finally, what keeps you motivated?

Kirby Shanks: I continue to be fascinated by the opportunity and intrigue of the markets. Having been and investor since the 1980s and having studied a fair amount of financial history, I believe Kanos has the resources and brain power to absorb lots of information and make good investment decisions. I also feel that the United States still has by far the best opportunity for business because of our governmental, legal and business frameworks, even though some of the American advantages have been watered down over the past few years. In spite of the trading/momentum-driven markets best epitomized by Jim Cramer and his one-sentence trading rationales, I still believe the markets provide a means to find great investment opportunities and build wealth, in spite of spates of irrationality and governmental meddling.

The Managers of Kanos Capital Management
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