May 2016

Dear Clients and Friends:

As I type this letter at my stand up desk, drinking a boutique artisanal kombucha after having just ate a very nice kale salad at lunch it hits me….there is a theme here. Whether it is food trucks, craft beer, gourmet cupcakes, specialty popsicles, music festivals, kale, beards or stand up desks; I have a sneaking suspicion that we will have fewer of them in the future. Don't get me wrong, I love pretty much all of those things. I rocked a sweet beard this winter, I love craft beer and Amanda and I have attended the Hangout Music Festival every year since it started 7 years ago. But in reality these are probably some sort of bubble. We live in a bubble society and while we are always on the lookout for what the next bubble is going to be they are often only seen in the rearview mirror. Unfortunately another bubble is me writing one of these every quarter. My last one was in December and we may need to stop calling them quarterly investor letters. ☹

Standing Desk, Beards & Music Festivals

"You don't need to remind them *every* time that the bubble's going to burst."

While bubbles and "irrational exuberance" exist in all facets of our life, we are most aware of them in the capital markets. Understandably so, because if our favorite craft beer brewer went belly up we would be ok, but if our retirement went up in smoke it would be a different story. There are bubbles out there right now some of which will burst, some of which will slowly deflate and some of which will continue to fill up. I have no way of knowing where those bubbles are, but what I think is more important is working to find where the bubbles are not. I have discussed at length the underperformance of international stocks and emerging markets stocks vs US stocks over the past few years. I have also discussed the rabid outperformance of a very small number of growth oriented US stocks vs the rest of

the market. What we have not discussed as much is the relative underperformance of value stocks in recent years.

I am a big fan of value based investing and my assumption is that you are also if asked to choose between value and growth investing. Growth investing has outperformed value investing for 9 years, which is one of the longest of such periods in recent history. As we have discussed, what has worked best has been buying the popular growth names and not the more boring value names. Joel Greenlatt, who ran Gotham Capital, said in September 2015: "Buying only those companies that lose money has earned investors anywhere from 20-50% over the last twelve months." That is a pretty amazing statistic. Growth has outperformed Value 6 times since 1945 according to Euclidean Technologies. Each time, Value has had a significant recovery. Is the relative outperformance of growth stocks a bubble losing air? Only time will tell. Year to date through May 5th, the Russell 1000 Value Index is beating the Russell 1000 Growth Index by near 3%.

The last 2 years have been amongst the most challenging times in my 17 year career. Diversification has not worked, active management has not worked, and buying things that have gone down in value and look attractive has not worked. What worked during that period was owning a select few US stocks. The managers that we use were not looking to invest in what was currently working but more importantly what they felt would work going forward. Our managers did not want to invest looking in the rear view mirror because they wanted to look for where they bubbles weren't and allocate there. I'd rather find a deflated bubble lying on the floor that someone forgot.

Who is more foolish, the fool or the fool who follows him—Obi Wan Kenobi

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I love behavioral finance and economics. It is fascinating to look at how people's emotions play such a huge role in their investing views. We are all guilty of many behavioral biases. Bob Seawright has a great list here. One of the biggest is Recency Bias. Basically what has recently happened largely shapes what people think will happen in the future. When US stocks were down nearly 11% for the year at their worst in February, investors were the most pessimistic they had been since March of 2013. Now after a big rally, I would assume that has shifted people's views. Nobel laureate Robert Shiller does surveys about investor expectations. One question he asks is: What are the odds of a one day crash of at least 12% in the US stock market over the next six months? Most people give it a 10% chance or more, but in reality that is 10x the actual chance based on history. We remember the big crashes, 1929, 1987, 2008 and Yale professor Goetzmann says that the echoes of crashes can last for decades. Between 2006 and mid 2008 as many as 58% of professional investment advisors thought the chances of a crash were very low, we then began the worst bear market in decades. Those same investors turned extremely pessimistic in early 2009 about the same time the market lifted off again.

The investor's chief problem and even his worst enemy is likely to be himself— Benjamin Graham

There is a series of commercials I see and hear often from a "financial firm" discussing a video they have posted that you "need to watch". The website for the video is typically something like 2016warning.com or financialapacolypse2016.com. Funny thing is that the year before it was 2015warning.com and 2014warning.com the year before that. I'm sure some of you have clicked on some of those videos. It can be a boy who cried wolf type situation. Eventually we will have a bear market and they can say the predicted it the whole time, but we know the truth, right? My top managers have been allocating to depressed sectors and securities during the last few years. Value stocks, emerging markets and other areas looked very attractive and just were slow to make the turn. It comes down to time. I tend to think that many of these strategies are not wrong, they are just early.

With Evermore's David Marcus

I have been fortunate to develop great relationships with a number of the money managers that I use to manage portfolios. I was recently named as a member of PIMCO's Independent Financial Advisor-Advisory Council. I was very honored to have been asked to serve a 2 year term in this position which will give me great access into one of the world's largest money managers, but also it will provide a platform for me to let PIMCO know my thoughts on what my clients are thinking. My first meeting will be in Newport Beach next month. I also was fortunate to spend some time in February with David Marcus of Evermore Global Value Fund. David and his team came down and we met for lunch. I began allocating to Evermore last fall and I am very excited about our future together. David is absolutely searching for those deflated balloons on the ground.

So to finish this long, rambling letter I will say we all need to be prepared for change. I wrote about change in my May 2015 letter. We quite often live in little bubbles. How often have you thought that things sure are perfect in your life and soon a change comes that shakes that thought, or even a comment about how it sure has been a nice month without rain and soon there is a massive downpour. Markets are no different. We need to remember that things that have done well aren't going to always do well and things that have done poorly are not always going to do poorly. I will continue to trust managers who invest with the knowledge that what is comfortable and popular is rarely profitable. Moral of the story-don't get too used to that gourmet cupcake or local food truck. You may wake up tomorrow and find out that it has closed.

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