November 14, 2013

Dear Fellow Investor:

The only thing left is the belief in Fed magic. Stocks are broadly the most expensive ever according to a critical metric and growth in earnings is becoming harder to find in individual names. Many stock investors still believe in magic, but when do participants decide that they are no longer being compensated to own equities? At the same time, sectors of the economy that were pointed to by many as strong and supposedly helped by QE are now struggling. For instance, whether looking at mortgage activity or various surveys for home purchases, it's clear that the housing sector has cooled extensively in recent months as rates have risen and hedge funds begin to try to liquidate properties. Also, auto sales, which have been propelled by a sub-prime lending surge, are softening as well. In the real world, the magic is gone.

The Fed has created a bizarre feedback loop in which the Street will focus on a sliver of hope like the roughly 200,000 mostly low quality new jobs from October's report as an economic positive that will cause the Fed to reduce the pace of QE. That is interpreted as good for stocks and bad for bonds. However, the ensuing rate rise ultimately hurts the real economy. This loop has been going on since the spring. The bigger picture is mostly ignored. For instance, the labor force participation rate, a more robust measure and one that correctly demonstrates profound secular weakness, is at levels last seen in the dark days of 1978. In addition, personal consumption growth slowed to just 1.5% in the third quarter.

Listening to the leaders at the Fed these days is like hearing the best students in the class arguing with the teacher over a grade. Much of the media seems like parents arguing on their child's behalf. For the guys at the Fed, who mostly know academia and nothing else, low grades would be crushing if they were not delusional. The class in this case is Real Economy 101 in which the Fed has helped guide the labor participation rate to thirty-year lows. Too many twenty-something's reside in their parents' basements for lack of a good job and older workers have given up looking for work in droves. Nonetheless, our brave students at the Fed are just certain as can be that money velocity will rise sooner or later, as their printed money finally gets put to productive use in the real world. Doubters like us must prove the "counterfactual" (a popular word among the FOMC acolytes these days) that things would be worse without the heroes at the Fed who have rescued us every five years or so from the popping of the bubbles they helped blow.

The FOMC swears it deserves an "A+" because stock prices are so elevated and speculation is rampant again. Numerous pundits praise the wisdom of Chairman Bernanke. However, for the first time we can recall, a number of significant money managers and captains of industry have

| 6800 Paragon Place, Suite 201 | Richmond, VA 23230 |

voiced concerns that a bubble has formed in many asset classes. But the Fed supposedly knows better! Though there is so little real world experience within its ranks, somehow the central bankers' good grades in school and fancy research papers replete with indecipherable squiggly lines trumps the wisdom of people who really do not have a vested interest in sounding cautious.

We will give them their coveted A+ in one subject: Bubble Formation 101. They have been receiving that grade for over twenty years. Equity bulls are now running over 3.5 to 1 versus bears according to sentiment surveys. Margin debt and mutual funds flows are at euphoric extremes. Tech companies with no earnings are priced into the stratosphere. A++! We also give them an A+ in Capital Misallocation Strategies 101. The FOMC is causing money to flow into markets and not into productive capital. They openly sell the "sizzle" of their magic trick. However, does the Fed think that business decision makers are so naïve as to believe anything in the current environment is real or sustainable? Will higher stock prices lead to job growth?

Why you may ask are we so hard on the Fed. It is because their policies at these extremes help so few and penalize so many, especially savers. Even some from the inside the Fed are beginning to recognize the shortcomings and unintended consequences of current policies. In a recent piece in the *Wall Street Journal* Andrew Huszar, the man put in charge of the Fed's mortgage purchase program wrote:

"I can only say: I'm sorry, America. As a former Federal Reserve official, I was responsible for executing the centerpiece program of the Fed's first plunge into the bond-buying experiment known as quantitative easing. The central bank continues to spin QE as a tool for helping Main Street. But I've come to recognize the program for what it really is: the greatest backdoor Wall Street bailout of all time."

Better late than never we suppose.

By the most important measures, U.S. stocks are the most richly valued that they have ever been in about 100 years of history, in spite of the underlying economy needing life support and pain killers for five years now. We predominantly use normalized earnings to value equities in an effort to adjust for cyclical earnings variability and typical profit margin behavior, but a more direct and less "geeky" way to get to largely the same answer is to compare stocks to annual revenue figures. On that front, data-centric fund manager John Hussman recently wrote:

"While the valuation of the S&P 500 Index itself was higher in 2000, it's notable that the overvaluation of the S&P 500 was skewed in 2000 by extreme overvaluation in very large-capitalization stocks, while smaller capitalization stocks were much more reasonably valued. In contrast, we have never in history observed the *median* stock as overvalued as we observe presently. Indeed, the median price/revenue ratio of stocks in the S&P 500 now exceeds the 2000 peak. Likewise, as Damien Cleusix has observed, if we examine valuations by quartiles (25% of stocks in each bin), the average price/revenue ratio of the two middle quartiles also exceeds the 2000 extreme."

Yet comically, former Chairman Greenspan had the audacity to recently argue stocks are cheap. The next Fed Chair, Janet Yellen, just told us today during her confirmation hearing that there is no “over leveraging in the markets” and no “misalignments in asset prices.” Why worry?

We ask that if the economy is not strong enough to stand on its own two feet why we should be more concerned about bond exposure and not at all concerned about equity exposure. Thus, we find yields of 4-6% in higher quality closed-end bond funds at 85-90 cents on the dollar to be extremely compelling. On the stock side we are still long companies with more stable cash flows that are much more reasonably valued than much of the market, but we are trimming. We still think many of our longs should be the very ones priced at a premium to historical valuations in this sort of environment, but many are not. Nonetheless, the equity landscape will likely become more treacherous. We reiterate that the market is, as always, composed of individual stocks. In the last twelve hours Cisco Systems and Kohl’s have told all who are willing to listen that it is very difficult to make money out there due to the macro picture. While we have no major positions in either of them, those who own those stocks are facing reality, magic or no magic. How many investors who own those names felt that the Fed had their back?

The reality is that investing will always be a risky endeavor in spite of temporary periods when the downside is ignored. Three times in fifteen years we have witnessed major doses of reality in which investors have been wiped out and sadly we expect they will again. That said, we would not be at all surprised to see equity indices move higher. We have been around the block a few times and know how bubbles play out. However, we also know that we are not willing to risk trying to precisely time an exit from a large stock exposure.

With equities up 25% this year and many hedge fund indices posting returns in the single digits, many are asking themselves why bother with a risk-controlled strategy. We are obviously below break-even in our partnership and I do not give myself good grades at present. I have made my share of mistakes, no doubt! However, our return profile this year and that of many other similar funds is not at all surprising when looking at the facts. We use historic valuation parameters to calibrate our risk exposure and a move to all-time high valuations with the lowest quality stocks dramatically outperforming effectively make ours risk-models obsolete…..so far. We began the year with a net exposure that would have been profitable if our lower quality shorts had not performed so poorly for us. While precious metals exposure has certainly detracted, it was the fact that in spite of such a weak economic backdrop and flattening earnings, many investors chose to focus buying in those stocks with the highest valuations and least predictable earnings where are short positions reside in a Fed printing frenzy that was somehow also bad for gold and bonds.

The Fed is in a horrible predicament of its own making and central banks across the globe are in similar quandaries as they move to devalue their currencies to service massive debts. Japan’s massive QE effort deserves special mention as another liquidity binge showing up in markets. Yet their magic appears to be dissipating for now as the Nikkei has stagnated and GDP growth has slowed substantially. U.S. equities are the most expensive level ever in our minds with little sustainable economic growth to show for it**. As for investors, a long-only investment in stocks is a bet that they will become more expensive than the most expensive ever.** If ever there was a time for an absolute-return focus like ours it would be the present, but anyone who has managed other people's money knows too well that many times investors lose faith at the wrong times and we get that. With the changes in our investor relations area last year and the tough market environment we were quite sorry to lose some cherished limited partners as depicted in the recently distributed third quarter fund accounting. At the same time, we thank again those of you who have referred new investors our way! We think that patience and adherence to our disciplines will be rewarded handsomely.

We are 125% long and 42% short with a net exposure of 8% on a risk-adjusted basis. We have approximately 68% of our capital invested in medium to higher credit quality closed-end bond funds and fixed-income ETF's which reside near multi-year low prices. Precious metals-related equities are a 7% exposure and remain our insurance against central bank induced global currency debasement. On that front, we do not think that the massive vaults being constructed in China and throughout Asia are being built to house Twitter or Amazon stock certificates or U.S. Dollars, Yen or Euros for that matter! Please call with questions and comments.

Sincerely,

Scott E. Brown, CFA

scott@strategicbalancellc.com