August 18, 2016

Dear Fellow Investor:

We sense profound frustration among investors and the electorate and it seems to be building. We also wonder what else the central planners can do and what would happen to markets if their meddling was curtailed because the realization that they are doing more harm than good became impossible to ignore.  Recent comments out of the Fed seem to suggest growing doubts within it about the effectiveness of its monetary policy regime of the last five years.  Meanwhile, the ECB and BOJ are overwhelming markets and crowding out traditional participants in their gigantic QE activities with no real improvement in their respective economic fortunes.

This landscape makes us more patient when others appear to be less so.  We do know we cannot fathom blindly paying the current high valuation multiples in any environment, let alone one in which EPS growth is so challenged.  We have been discussing for some time now how the typical equity is trading about twice its normal valuation.  One can look at a number of different metrics and indices, but the conclusion is often the same.

A rational investor should look at the graph below of small cap stocks over the years and conclude that one does not need to be in any hurry to broadly buy them. Relative to twenty years of data they are enormously expensive when comparing Enterprise Value (Debt + Equity Market Capitalization) to EBITDA (Earnings before Interest, Taxes, Depreciation and Amortization).  If you went back further in the data, the conclusion would be the same.

*Zerohedge*

Because of valuation metrics like this, we have been well hedged in equities for some time.

We are 89% long and 50% short. Closed-end bond fund holdings are at a 43% total position (12% municipals, 11% TIP's, 9% mortgages, and the remaining 11% in a mixed bag of sectors). We are still most excited about our short positions.

We have hedged up some of our interest-rate and precious metals exposures.  We think that the rally of recent months has presented compelling opportunities to run a more matched book just as it looks like the central planners have run out of "rabbits and hats."  For instance, some of the gold miners have run well ahead of fundamentals and so we have placed some small bets on the short side.  At the same time, utilities and REIT's have become quite rich, enabling us to offset some fixed-income exposure in our CEF longs.

While we have made just minor changes to our portfolio, we think they are in keeping with our current theme of risk reduction that began with closing out positions on the long side some months ago.  We are fortunate that our themes have worked out well for us this year and continue to place a premium on flexibility.  We are confident that compelling investment opportunities will present themselves soon enough.

Sincerely,

Scott E. Brown, CFA