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Excerpts from Year-End Report Written by Investment Partners Asset Management – Q4 2013

"…Initially, the Fed's assurance that low short-term interest rates through at least 2014 was all the equity market participants needed to hear. As time went on, the Fed's grasp on longer term rates was slipping. A willingness to accept greater inflation as a means to spur consumers to spend was seen as a reason to expect higher interest rates which in turn could dramatically affect the US economic recovery.

Furthermore, historically, markets tend to anticipate inflationary effects well in advance and perceive an even modest reduction in stimulus as credit tightening. Throughout 2013, it was ironic how market perception had its own way of becoming reality. Two times during the year the Federal Reserve hinted at a change in policy - each time the market receded only to be followed by a period of complacency and reduced market volatility. A belief system was forming that the economy was about to spurt at a healthy clip: not too strong - but not at all weak. Despite modest overall earnings growth and revenue projections of American companies, the markets discounted an outsized recovery - thus the U.S. markets performed well in 2013.

In a consumer society like the United States, deflation develops when consumers curtail spending, particularly when they are worried about their jobs and economic future. In a natural business cycle, savings increase to a point at which the pent-up-demands begin to encourage spending again. We are not there yet. Modern-day economic theory suggests that it is government's sacred duty to create an environment that forces the population at large to spend. One such method is the creation of money that produces sufficient inflation, which in turn toys with the consumers' psyche, enticing consumers to buy now before prices go up. The Federal Reserve has a dual mandate - price stability and full employment. Monetary policies that are accommodative normally encourage spending rather than savings. Consumption creates demand, which encourages industry to borrow to create the capacity to fulfill demand. The theory goes that employers ultimately need to hire labor to produce output, and as jobs become scarce, wages rise. In the end, the overall economy gets back to normal – problem solved.

Creating debt however, which the Government has no intention of fully repaying in today's dollars, takes capital from the productive sector and transfers it to others. In any normal lending scenario, such terms would be unacceptable to a reasonable creditor. Advanced societies in mature economies reach a point where the temptation to accelerate credit expansion to counteract deflation does no good. In our opinion, we are at that point. In such an environment, known as stagflation the economy stalls, prices rise and profit margins narrow. The cost of essential products and services rise, outstripping the income earned from work or the interest and dividends from savings and investment.

Another effect of continuing accommodative Federal Reserve money creation is asset inflation. In our opinion, offering fixed income investors relatively unattractive yields on government paper has the effect of making investors seek returns from risky assets – potentially creating an asset bubble in certain segments of the market. Our hesitancy to be fully invested at any time in 2013 resulted from the recognition that the fiscal deterioration of the nation, caused by too much spending at all levels funded by debt, would inevitably hurt consumers, investors and the overall economy.

After an expenditure of over $4,000,000,000,000 economic conditions have only marginally improved. Some investors, savers, those living on a fixed income and the unemployed, are not happy with the result. Bond holders in 2013 were also not happy - and neither were investors in emerging nations, nor holders of interest-sensitive real estate trusts, or utilities.

The Federal Reserve is no doubt aware that historically, markets tend to anticipate the inflationary impact of a continuation of manipulative intervention activities. They know that inevitably such actions are bad for financial assets of all types. In spite of that knowledge the experiment continued throughout 2013. Equity markets in the developed world for the most part loved it. Price to earnings ratios expanded in spite of tepid GDP growth. Corporate profits of many companies that make up the S&P 500 expanded while overall revenues only grew modestly…

ISSUES AND CHALLENGES

Despite the phenomenal performance of the broader market equity indices referenced above, we, as well as a number of famed value investors, found 2013 to be a somewhat frustrating year. It is always a pleasure to see the market perform, and to make money for investors - that goes without saying. It can be worrisome, though, when a number of the poster-children of the 2013 stock-market rally have valuations which appear, to us, to be totally detached from traditional valuation metrics.

Along those lines, one of the most fundamental analyses a value-oriented investor makes is to ask the following question: 'If I had an unlimited amount of capital so that I could buy all of a particular company's stock at its current market price, how many years of net earnings would it take to earn back my initial investment?'

The answer to that question is pertinent to understand the performance of certain Wall-Street-darlings of 2013. By way of illustration here are a few stocks that, in our opinion, appeared to defy gravity last year.

- **Amazon.com** – approximately 100 years
- **LinkedIn** – approximately 100 years
- **Tesla** – approximately 100 years

Giving these companies the benefit of the doubt that their accounting methods are sound – but using current financial metrics, it would take approximately 100 years of Amazon.com's, Linkedin's or Teslas' net earnings to make back your initial investment if you were to own the entirety of these companies at their current valuations. That would put you well past the year 2100 before you broke even from having laid out the capital on these investments (assuming they were able to earn the same net income that they do at this point.) It is, of course, hard to imagine what life will be like 100 years from now, so to put this amount of time into perspective – let's think about what life was like 100 years ago. In 1913 the average individual income in the United States was $800 per year, and the average life expectancy was about 53 years. Henry Ford introduced the assembly line at that time, and "When Irish Eyes Are Smiling" topped the charts. A mere 2.3% of the population had a college degree, and women were not yet able to vote. Wow – that was a long time ago indeed! But wait, there's more…Let us look at…

- **Netflix** - approximately 200 years

Using current financial metrics, it would take approximately 200 years of Netflix's net earnings to make back your initial investment if you were to own the entirety of the company at its current valuation. That would put you well past the year 2200 before you broke even from having purchased the company (assuming it were able to earn the same net income it does at this point.) Just as above, it is probably hard to imagine what life will be like 200 years from now, so to put this amount of time into perspective – let's think about what life was like 200 years ago. In 1813 rubber was patented, and the first pineapples were planted in Hawaii. Napoleon defeated the Austrians at the battle of Dresden, and the British took Fort Niagara in the battle of 1812. The image of Uncle Sam was first used to refer to the United States, and, as we all know, Beethoven's 7th symphony topped the charts.

- **Twitter** – infinite number of years (i.e. not projected to earn a net profit at this point)

Laying out approximately $35 billion might take you until the apocalypse to recoup your investment (assuming they continue to earn the same net income that they do at this point). Since that might be hard to conceptualize, looking backwards in time would put you, more or less, at the Big Bang.

Future dividends, you say, could justify an investment in these overvalued stocks – except they don't pay any. Since the perception is that they will continue to grow very fast, there has been no reason among market participants to question their current valuations. Only growth-minded institutional investors, hedge funds, and momentum theorists can play in this overheated arena. For us, as value managers, we have to pass.

2014 OUTLOOK

At the end of 2013 analysts were predicting a continuation of market momentum with rising equity prices based essentially on the following beliefs:

- A change in leadership at the Federal Reserve from Ben Bernanke to Janet Yellen would have minimal impact on Fed policy.
- Reduction of Fed asset purchases would not have unintended consequences particularly in the housing market.
- Normal domestic economic growth would be sustainable.
- There would be a consumer led demand cycle accompanied by a decrease in unemployment.
- Equity markets would anticipate better times ahead, price to earnings multiples would expand, albeit not as fast as 2013.
- The "wealth effect" would encourage consumer spending.
- Industry would get more confident and invest in plant and equipment once they could forecast demand with more certainty.
- Global expansion with rising world trade, improved capital availability and functioning credit markets would sustain a worldwide boom.
- The dollar would remain strong.
- The U.S. would continue on its path to Energy Independence.
- With the implementation of the Affordable Care Act health care, costs will come under better control.

So, as we continue down the road in 2014, we find ourselves not completely embracing the consensus view largely because an analysis of the data does not seem to support the reasoning for many of these beliefs. In our opinion, the risks of any errant policy coming out of Washington, Europe, the Middle East or Asia could change investor perception and deal a blow to investor and/or consumer and business confidence at any time. There is now sufficient evidence that indicates the Fed's interest-rate machinations have done little to instill enough confidence for the economy to grow at other than an anemic pace. They say quantitative easing measures have been accompanied by quiescent inflation and there is improvement in housing and employment. Because interest rates in general were at historic lows the stock market became the place to be by default. Economists believe that rising asset values, the so-called Wealth Effect, leads to spending. In reality, the citizen's cost of living is increasing faster than wages, leaving little for discretionary spending.

So far the rise in spending has not been impressive as consumers continue to deleverage. In support of our skepticism were government statistics indicating to us that there were no measurable, tangible, sustainable benefits from prior quantitative easing experiments. Creating over $4 trillion in liquidity should have created a healthier economic rebound. Instead, nearly five years after the financial collapse, economists now anticipate an improvement in GDP growth to 2-2.5% for the first half of 2014 followed by 3.5-4% in the second half. Most all of this depends on global growth of at least 4% in emerging nations like China.

With the uncertainty brought about by the European recession and a slowdown in the Chinese economy, we see a real possibility that these growth rates do not materialize. We are therefore positioning the portfolio for a period of stagflation in early 2014 which if left unattended could result in recession in late 2014. The economy is still fragile and vulnerable. Any unanticipated shock to the system, during a period of consumer deleveraging and government induced austerity, is likely to limit expansion as it already has in Europe.

The Fed's purchase of Treasury debt has created a scarcity and induced an interest rate so low that savers and investors cannot get a suitable return on their investment at a premium to real inflation. In short, Federal Reserve policies since the first quantitative easing created a boom in the stock market but not much more. In addition, unemployment statistics understate the true amount of financial hardship felt by the middle class worker. This is not just true in the private sector.

With mounting problems in Puerto Rico, Illinois and big urban cities, the municipal sector appears to be weakening. Budgetary strain with a curtailment of services, salary caps, layoffs and head-count reductions are now more likely adding to the ranks of the unemployed. Essentially, the states and cities can't print money and have to work with balanced budgets. In the future, they will have an increasingly hard time borrowing money. As a result, they have no choice but to become more austere, raise taxes or cut essential services.

We believe that the eventual unwinding of massive public debts will impact virtually every American because taxes at the local level will rise along with interest rates. When government curtails spending, unemployment (already a problem, both politically and economically) will rise, leading to cuts in entitlements, and rising interest rates. Access to credit will be limited and will be based on the credit worthiness of the borrower rather than be set by Federal Reserve meddling.

Simply put, this is not exactly the environment that should have rewarded investors in 2013, so we don't see a repeat performance in 2014….

…Now we are not quite sure that the economic situation will not worsen before there is a dose of reality. As a consequence, the overall investment environment has grown more challenging. The stock market is at a historic high, the world is awash in liquidity and interest rates are still near historic lows. Housing has shown some sign of recovery, depending on geographic location, but mortgage rates have risen, threatening the recovery.

Some important issues have surfaced:

- The Federal Reserve has signaled a reduction of their asset purchase program which is, perhaps falsely, being interpreted as credit tightening.
- Longer-term Interest rates are rising because of market forces outside the control of the Federal Reserve.
- The economy is not strong enough for the Federal Reserve to completely abandon quantitative easing.
- Unemployment remains stubbornly high with workers earning less disposable income.
- European economies of the debtor nations are not quite strong enough for the central banks to remove their stimulus programs.
- Fiscal imbalances are still present with political gridlock.
- Global growth in China is not assured, Japan's credit creation, tantamount to currency devaluation, produces added uncertainty.
- Middle East tensions could plunge the region into chaos.
- Competitive currency devaluations could lead to capital controls and a wave of protectionisms.

A major theme underlies our investment posture: we may have seen the last of low interest rates, the low-to-no-growth environment in the developed world may be with us for a lot longer, and some form of inflation will likely develop as a consequence of profligate money printing. We don't see the economy picking up markedly, or growing much above trend this year. As we head into the second half of 2014, we believe that the equity markets will have less and less confidence in orchestrated central bank initiatives here and abroad. What the markets are telling us so far is that the rest of the year will be a lot more volatile and that the easy money has already been made.

The question, then, is where do we go from here?

One of our most important overall strategies is to remain opportunistic by meaningfully participating in markets and sectors that we believe will draw investor attention. One such area is the technology space. We continue to believe that modern technology companies are the future growth engines of the economy… in computers, internet, semiconductors, telecommunications, and software companies that could be categorized as participants in the technology space serving domestic and worldwide markets. On a technological level, mankind continues to become more productive, learning to do more with less – and that trend is not likely to cease any time soon.

Furthermore, in the coming months we also expect that the domestic and international issues and challenges will be brought into greater focus. We remain convinced that in 2014 there will be an honest attempt to formulate a national energy policy – hopefully with a particular focus on natural gas exploration and production, transportation, and infrastructure development….

…Finally, we believe there should be some protection against the possibility of renewed inflation. As such, we remain convinced that there is significant value in mining and minerals as well as precious metals… If any of you would like to know more about our investment style or have any questions or comments please feel free to contact us."

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