



Quarterly Newsletter to Clients Q3 2011

September 30, 2011

Executive Summary

We now have confirmation that the US economy is heading into recession and have begun taking risk off for our clients.

- The US is entering recession now or next month. The global economy may follow and while we do not believe, at this time, a repeat of 2008 is ahead the evidence supports a reduction of risk.
- Margin of Safety works. But the time period for it to work can vary during volatile economic periods testing the patience of investors.
- Those managers we dub Long-Term Less Volatile are the rare and precious few who have demonstrated sufficient resilience during tough economies to remain a core holding for our strategies and have showed positive returns even during most recessionary periods.
- We have reduced risk in all of our discretionary strategies by selling the More Volatile investments. We are in the process of reallocating the cash from sale into Volatility Control managers appropriate for the investment climate. While we understand there may be a short-term market bounce, an analysis of historical recessions clearly illustrates that risk outweighs reward at this point in the economic cycle.
- At substantial expense to us, we believe the ongoing subscription to the Economic Cycle Research Institute data and our new Trade Warrior trading software will be useful in our attempt to continue to provide superior risk-adjusted returns.
- Finally, we fully understand ERBAA is not a panacea. Nonetheless, the evidence suggests sustainable upside opportunity in the broad markets will not be present until we get a signal for a new Economic Expansion.

Implementing Economic Risk Based Asset Allocation (ERBAA)

“Don’t assume the muddle through world will be back anytime soon. Be bottom up all you want, but pay attention to the top down.”

Jean Marie Eveillard, First Eagle Funds

Based on ECRI’s recent recognition of economic recession, we have taken *all* More Volatile investments off the table for discretionary portfolios. Historically, the performance of MV managers has been volatile during recession. We are prepared to experience some short-term pain that may make us and clients regret this reallocation in the short-term. In the past markets have often exhibited a dead cat bounce (stocks rising) after the onset of a recession. Nonetheless, we believe this is the right decision because it removes much of the sharp downside risk should we fall into a deep recession like we did in 2008. Based on a historical analysis of returns during recession, stocks were mildly positive (returns less than 7%) 3 of 10 times. So, in short, the risk of owning the MV managers during recession outweighs the potential reward.

There are a number of reasons this reallocation may appear to not work as intended. ECRI’s information could be wrong, we may not correctly interpret their call, or their call may not produce the desired results. Our subscription to ECRI data makes sure we will not miss the

call. However, there is no guarantee that ECRI's call will be right or that some government intervention could temporarily override the market's reaction to the economic cycle. If you want to read about our examination of the risks of implementing ERBAA, see link:

[Implementing Economic Risk Based Asset Allocation \(ERBBA\) with MOS September 6, 2011](#)

Again, we, like Jean Marie Eveillard, wish we could be agnostic about the economy, but the reality is that risk asset prices tend to react based on fundamental changes in the economy. We agree with our managers that security selection works. It is only a question of time horizon (expected investment duration). Nonetheless, with the high level of debt in developed nations, the overall lack of confidence in government, and the global economy going into recession or severe slowdown, we believe an extra level of caution is in order.

We define the differing stages of the economy, which occur after peaks and troughs in economic growth as Expansion (after a trough), Slowdown (after a peak during expansion) and Recession (a further slowdown into negative growth after a slowdown). We use this information to add an *extra layer* of attention to all of our portfolios, exercising a lighter hand for more Risk Tolerant investors (the bulk of our Long-Term Portfolio clients) and a heavier hand for Risk Averse investors, who are comfortable with greater opportunity cost in return for lower volatility.

Our rationale for making these changes is based on an extensive examination of historical returns during differing periods of Economic Expansion, Slowdown, and contraction (Recession). For example, during past Expansions, investments that responded best were typically cyclical. MV investments did better during this period. During Slowdowns, LV investments did well, generally experiencing strong positive returns while MV investments did more poorly. During recessions, while LV investments have often done well, only lower risk VC investments did well consistently.

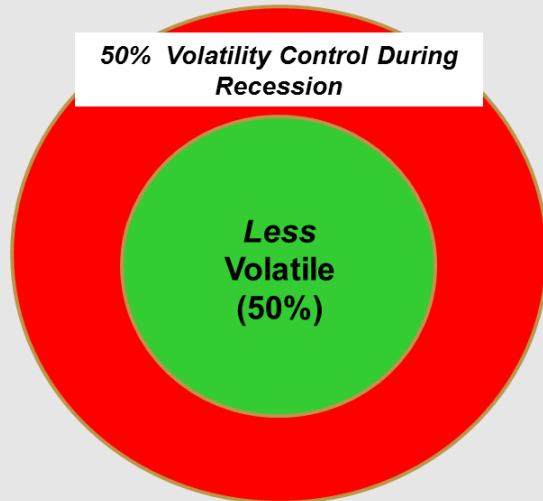
We ran some simulations on how this would have worked if we had used this process over the last decade. To see this visit our newsletter, ERBAA Back-tested:

[Economic Risk Based Asset Allocation \(ERBBA\) Back-tested August 29, 2011](#)

To be more precise, in our Long-Term Portfolio, the Risk Tolerant strategy will always have a 50% weighting in our Long-Term Less Volatile (LV) managers like First Eagle Global or IVA Worldwide (closed to new investors but available to our current and new clients). The LV investments will comprise the core with VC and MV investments used to reduce risk (during Slowdown and Recession) or enhance return (during Expansion) as appropriate.

The chart below illustrates this.

Long-Term Portfolio: Risk Tolerant Allocation Concept



Concept for Risk Tolerant investor seeking 10% plus annual return

- 50% of Portfolio is allocated in Less Volatile investments at all times.
- 50% allocated according to Economic Risk
 - Expansion: 50% in More Volatile investments which exceptional upside
 - Slowdown: 25% in More Volatile investments and 25% in Volatility Control investments
 - Recession: 50% in Volatility Control Investments

Long-Term Portfolio Risk-Tolerant			
	Expansion	Slow Down	Recession
Volatility Control		25%	50%
Long-Term Less Volatile	50%	50%	50%
Long-Term More Volatile	50%	25%	

We will also be reducing risk for Risk-Averse portfolios as below:

Long Term Portfolio Risk-Averse			
	Expansion	Slow Down	Recession
Volatility Control	20%	50%	75%
Long-Term Less Volatile	40%	50%	25%
Long-Term More Volatile	40%		

We received the signal to reallocate based on the Recession this week. This means we are taking all MV investments off for all discretionary portfolios. We are also removing VC investments that we feel are riskier than is appropriate for recession. Again, during Recession, we are worried about controlling volatility than generating high returns. For example we will probably be selling investments focused on high yield bonds. Whenever we receive the signal to reallocate, we may also change the mix of investments we use based on the expected interest rate environment, valuations, and other criteria, but the overall broad framework will remain constant unless we learn some better way of doing this. For example, historically, high yield bonds and long/short VC strategies have worked relatively well during slowdown and LV managers have worked well during most slowdown and even recessionary periods. However, MV investments have typically worked less well than LV investments during slowdowns and recessions as we see now with some of our MV holdings, especially the Fairholme fund. Moreover, high yield strategies also have longer durations during recession, so we are eliminating them.

The Economic Cycle Research Institute (ECRI) has done a phenomenal job at predicting when key inflection points occur in the economy; they generate our signal to reallocate. To learn more about this, read our paper on it.

See LINK: [Economic Risk Based Asset Allocation June 20, 2011](#)

Our subscription to ECRI provides us decision points for allocating risk as **we have high confidence we will get a signal to take additional risk when a new Expansion is signaled**, which could occur as early as in 5-6 months.

In order to implement ERBAA effectively, in a time efficient fashion, we have also purchased a trading software system, called Trade Warrior, which will allow us to be more nimble when needed. These subscriptions and technology come at a substantial cost, but we feel the cost is more than justified in our attempt to provide superior risk-adjusted returns for our clients.

The Importance of Margin of Safety and Investment Duration

All things equal, we like to exercise a light hand when reallocating portfolios away from managers who we feel exercise a Margin of Safety managing investments. These managers are incredibly rare and extremely difficult to find. It is worth reiterating: they comprise a small subset of the investment universe (we think less than 1-2%). Their focus on preserving *permanent* loss of capital through extensive bottom up security analysis is a skill seemingly lost to the investment masses (including “professionals”), as has been well articulated by Louis Lowenstein in The Investor’s Dilemma. Instead of focusing on technical analysis or short-term market movements, these managers read several years of annual reports, gain an understanding of company balance sheets and hidden assets and develop an intrinsic value for the securities they purchase by calculating normalized earnings based on conservative growth estimates. So, in order for us to override this, we need strong evidence that doing so is warranted.

After extensive back testing of the data (and our own experience of how these managers have worked during previous economic slowdowns and recessions) we feel it makes sense to hold the Long-Term Less Volatile (LV) gems as a core to our Long-Term Portfolios. All of our managers typically self-regulate risk by owning more stable securities during weakness, including cash where appropriate. This is more prominent in our LV managers. The best example of these is the First Eagle Global fund, which has a track record back to 1979 of providing steady risk-adjusted returns including positive calendar year returns for the entire period except for two years (98: -0.3% and 2008: -21%). These LV managers defy modern portfolio theory. We use them as the core of our Long-Term Portfolios. During historical periods, these managers (and other strategies similar to them during the 1970s) have often experienced positive returns during periods where the US economy was in extended slowdown or even in recession.

See LINK: [How We Select, Categorize, and Fire Managers April 25, 2011](#)

The securities owned and the degree of diversification of our Long-Term More Volatile (MV) and Long-Term Less Volatile (LV) managers differ. MV managers often own more volatile stocks (often distressed and cyclical companies) in higher concentrations. This has historically made their returns superior during bull market periods of economic Expansion and inferior during bear market periods during extended economic Slowdown and Recession. Likewise, LV managers typically own higher quality, less volatile stocks with smaller, more diversified position sizes. We believe both will work over time; however, the expected duration for them to work will vary. We expect LV managers to work over shorter durations, typically with very high confidence over 3 year periods. We expect MV managers to work over longer durations

of up to 5-7 years under worst situations (The Super investors generally worked over 4 year periods in the 70s). While we believe a permanent allocation to these MV managers would work, given time, and provide superior performance to indexes and possibly even the LV managers, we understand that investors are impatient. For this reason, we intend to use Economic Risk-Based Asset Allocation, discussed below, to lessen the duration risk of the overall portfolio by making an active choice as to when to use MV managers and alternatively, when we use Short-Term Volatility Control (VC) managers.

Economic Update and Market Outlook

ECRI confirms the US economy entered *Recession* in August or September or will do so in October of this year. The rest of the world may follow as the US consumer still leads the world. Moreover, Greece and Portugal MUST default in some fashion because the level of debt in these struggling economies cannot be repaid in Euros at face value. The challenge facing the European Union is to administer this default in an orderly fashion so that European banks (which are undercapitalized) do not face a crisis when this debt defaults.

Valuations

While the US stock market, in aggregate, is still not cheap, Europe and Japan *are*. International stocks (outside of the US) trade at 1.2 x book value. Europe trades at 10 x normalized EPS. Japan trades at book value. Nonetheless, we believe the imminent recession is likely to be global in scope and that prices will get even cheaper. Investment strategies that do not incorporate a Margin of Safety and investors, who do not fully understand their investment duration, are likely to get hurt. Because valuations differ globally, we believe there are opportunities for LV managers, who are well diversified and seeking opportunities globally, to add value. Our clients who worked with our advisors since 2000 understand that First Eagle Global made positive returns in 2000, 2001, and 2002 because the valuations were so compelling overseas. While we cannot predict the future, this may prove to be true once again.

Concluding Remarks

We don't want anyone to believe ERBAA is a panacea. This recession could be a short and shallow recession and it is possible that stock prices could rise, especially in the short run. However, we made this very difficult decision to reallocate client assets because we feel the economic backdrop is sufficiently perilous that the potential for a repeat of a 2008 experience cannot be ruled out. Moreover, thanks to our subscription to ECRI, we will be notified when an Expansion begins anew in order to take risk again when this makes better sense. Since 1950, upturns in the ECRI Long Leading Indicator ALWAYS have anticipated upturns in stock prices, typically about a month in advance. Therefore, we believe our risk off reallocation is appropriate. Please be patient with us as we invest the proceeds of these sales into the appropriate VC managers.

Global View Team