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Q4 2013 Quarterly Letter

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We delivered strong returns in 2013 on both a relative and absolute basis. Our Equity accounts advanced 34.4% for the year compared to a 32.4% return for the S&P 500 and our Balanced accounts returned 23.1% compared to a 14.1% return for the benchmark (which is weighted 50% S&P 500 and 50% Barclays Aggregate Bond Index). These results were achieved despite maintaining significant cash balances which often exceeded 25%.

The robust returns in 2013 were a product of our individual equity holdings advancing approximately 46% during the year – outpacing the 32% return of the S&P 500 by a fairly wide margin. The breadth of gains were widely distributed throughout the portfolio with 23 of 24 positions producing positive returns (the lone exception was our new investment in Quest Diagnostics which declined by less than 5%). There were several key standouts which contributed disproportionately to the performance results, including: Best Buy (+238%), Crosstex Energy (+152%), Sprint (+80%), Legg Mason (+69%), and Chesapeake Energy (+63%).

This year's list of top five performers continued a similar trend that started in 2012. You will recall that 2012's top performers included both Sprint and Ingersoll Rand which were two of our worst performing positions in the prior year. Fast forward to 2013 and this year's list includes two of the worst performers from 2012: Best Buy and Chesapeake.

In fact, we highlighted the extreme negative sentiment surrounding both of these companies during 2012 and stated that their stock prices did not accurately reflect their true intrinsic value. Investors rectified this mispricing in 2013 as both stocks increased dramatically; and, in the case of Best Buy, actually surpassed our appraisal of fair value forcing us to sell the position.

For those clients with an allocation to fixed income, we generated strong returns on both a relative and absolute basis. Our corporate bond holdings returned +7.1% during the year compared to -2.0% for the Barclays Aggregate Bond Index. In addition, our tax-free municipal bond holdings increased +3.1% compared to -2.6% for the Barclays Muni Bond Index.

The outperformance can be attributed to two main factors: first, we intentionally own a shorter duration portfolio with less sensitivity to rising interest rates, and second, several of our bond holdings experienced improved credit quality on the back of better underlying fundamentals. This is a testament to the quality of research we conduct and the belief that a relatively concentrated portfolio of undervalued and highly-researched securities is a better way to generate long-term superior returns not only for stocks but also for bonds.

Stepping back for a minute, there is no doubt that the breadth and magnitude of this year's gains benefited significantly from the performance of the overall market. A rising tide does indeed lift all boats and it would be disingenuous to suggest otherwise. We have said before that one great year does not indicate investment brilliance, nor does one bad year signify investment futility. And while our individual investments produced superior absolute and relative performance in 2013, we would caution that this type of result will be difficult to replicate in any given year.

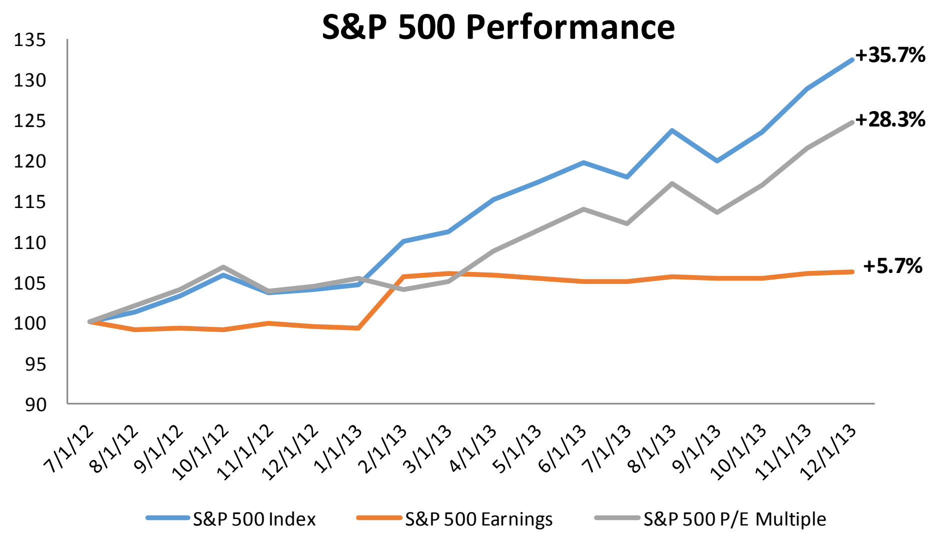
Unfortunately, the consequence of significant investment returns is the fact that we once again were net sellers during the year – continuing a trend that dates back to 2011. In almost all instances we liquidated positions based purely on valuation (we will discuss this subject in more detail below). While we were able to allocate capital to several new investments, this was more than outweighed by positions we sold. As a result, cash balances increased throughout the year.

During the year we sold five positions (Aon, Best Buy, Dell, Harman, Ingersoll Rand, and NCR) and purchased three new positions (Genworth Financial, Quest Diagnostics, and Titan International).

A Discussion on Multiples and Discount Rates

Since the market bottom in March of 2009 the S&P 500 has increased 178.9% (through December 31, 2013). While you are likely to hear many reasons justifying this rebound, the reality is that the price of a stock (and the market overall) is based on just two key variables: the underlying earnings stream and the multiple investors are willing to pay for that earnings stream.

It's fair to say that from the depths of the recession the market's rise has been fueled by increases in both earnings and multiples. However, more recently, the preponderance of gains can almost solely be attributed to a rise in multiples rather than a growth in earnings. Using the S&P 500 as a proxy, you can see in the chart below a comparison over the past 18 months between the increase in the S&P 500 index, earnings, and multiple:



Looking back during this time frame at the positions we liquidated, their subsequent performance tells a similar story. As the chart below shows, the average gain after selling a position was 19.9%; but over half of this gain was attributed to multiple expansion:

		Post-Sale Performance		
Position Sold	**Sale Date**	**Price Change**	**P/E Mulitple Change**	**Multiple Factor**
MA	9/25/2012	84.21%	39.25%	46.61%
AAP	11/1/2012	36.20%	6.80%	18.77%
IR	5/8/2013	11.48%	41.34%	360.25%
HAR	8/21/2013	20.85%	7.40%	35.47%
AON	9/24/2013	10.85%	9.67%	89.14%
NCR	10/16/2013	-16.66%	-21.77%	130.66%
BBY	10/28/2013	-7.92%	-4.20%	53.03%
Average		**19.86%**	**11.21%**	**104.85%**
Median		**11.48%**	**7.40%**	**53.03%**

1. Multiple Factor equals the P/E Multiple Change divided by the Price Change

Put another way, investors today are simply willing to pay more for each dollar of earnings than they were 18 months ago. With an improving economic environment and the perception of less uncertainty it's perhaps easy on the surface to rationalize paying more for the same unit of value. However, whether most investors realize it or not, the willingness to pay an ever-increasing price implies reducing one of the most integral aspects of financial analysis – the discount rate.

The concept of a "discount rate" is difficult to appreciate and even more challenging to explain – perhaps that's why most investment managers avoid discussing this subject in client letters (including yours truly). Yet, a true understanding of this concept is vital to intelligent investing, especially during a period when prices are rising and multiples expanding. Moreover, it goes a long way in explaining our rationale behind selling many of the names listed above.

The primary tool we use to value an asset is a discounted cash flow (DCF) model and one of the key variables in the DCF model is the discount rate. Essentially we calculate a company's excess cash flow after all expenses and capital spending needs and discount this back to a present value. We refer to this as a company's fair value. We typically purchase stocks that trade at a 40% - 50% discount to fair value and sell when they reach 100% of fair value. Our daily efforts are driven by the need to understand what this future stream of cash flows is worth to us today, despite the fact that it will be generated in the future. The key to all of this is – <u>the lower the discount rate used the higher the value of future cash flows, and conversely, a higher discount rate produces a lower value of these same cash flows.</u>

If the predictability of these future cash flows is difficult and uncertain, and there exists other opportunities to invest in either higher-earning or lower risk alternatives, than the discount rate applied to that investment should naturally be quite steep. Conversely, if confidence rises and uncertainty declines, then a lower discount rate might be warranted – especially if the opportunity set for other attractive investments is non-existent. This latter scenario almost perfectly describes the current investment environment.

The choice for an investor today is simple: do you pay a higher multiple, and in effect lower your discount rate, simply because the alternative (i.e. cash and/or fixed income) offers such a meager return?

Many market participants today have elected to do just that. On the other hand, the discount rate we use to analyze potential investments is little changed over the years despite fluctuations in investor sentiment and interest rates (this number has fluctuated between 9% and 10%). <u>Simply put – other investors are willing to use a lower discount rate and pay more for a stream of cash flows than we think they are worth.</u> We might actually agree on the stream of cash flows but we disagree on how much should be paid for them.

The inherent problem in this thinking is that most investors consistently extrapolate near-term events (whether it's euphoria or despair) perpetually into the future. As long-term opportunistic value investors, our preference has always been to "look through" the short-term noise and value investments based on a more normalized environment. For example, we do not assume that the 10-year Treasury rate remains below 3% in perpetuity.

When making an investment with the likelihood of committing capital for at least three years, and in some cases much longer, we think it makes the most sense to assume a level of uncertainty and opportunity cost that will perpetuate throughout the lifecycle of that investment – rather than simply extrapolating the current environment. A byproduct of this philosophy is a natural contrarianism which can be encapsulated in one of our favorite Warren Buffett quotes: “be fearful when others are greedy, and be greedy when others are fearful.”

A casual observer may look at the investments we recently sold and conclude, based on their subsequent performance, that we sold too early. However, these decisions were the result of a careful assessment of risk, opportunity cost, and the desire to remain patient and disciplined. Even though we ended the year with just 15 equity investments (the fewest since 2007), we take comfort in knowing that the remaining positions we own are truly undervalued even under a harsher spotlight.

We’re Moving

We are excited to announce that, effective April 1, 2014, we will be moving into new larger offices. This move will allow us to add additional investment resources and improve our client service capabilities. We encourage you to stop by and look forward to hosting you on your next visit.

After April 1st please be sure to direct any future correspondence to the following address:

12250 El Camino Real, Suite #320
San Diego, CA 92130

Annual Investor Meeting

We will be hosting our annual Investor Meeting this year on March 5, 2014 starting at 5PM. This year’s event will once again be held at the Estancia Hotel & Resort in La Jolla. You will receive a separate invitation by email so please mark your calendars accordingly. We look forward to seeing you all there and sharing with you our thoughts for the year ahead.

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