An Uncommon Journey

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Investing can sometimes feel like an odd game. Over the years, our success has been based significantly upon our effectiveness in looking at the big picture and thinking outside the box. Of course, the risk of that approach is that, during those inevitable periods when things happen to be going particularly well inside the box, you don't look innovative – you look out of touch. You can do an awful lot right and still look bad, at least for a time, so managing a process based upon independent thought takes both discipline and patience.

When we look back some years hence, 2013 will appear in its rightful place as but one segment of an investment journey we embarked upon over 15 years ago – with a year similar in some respects to the one just concluded. In 1998, after assessing with growing concern the way certain segments of the market were developing, we chose a different course, making some carefully considered allocation changes which ended up looking horribly out of touch in the short run, causing us to dramatically trail the broad U.S. equity market … for a time.

Beginning in early 2000, as our decisions began to look insightful and well executed, we were proud we had stuck to our fundamental discipline and resisted the temptation to follow the market into unfavorable territory. Now, as we enter 2014, though we do not yet have the luxury of knowing how subsequent events will play out, I am similarly pleased that, while we have made reasoned adjustments, we have stayed true to our discipline. Today's circumstances and concerns are far more complex than 1998, but we believe our logical consistency positions us well for things to come.

None of that means we're happy with 2013; we weren't happy in 1998, either. Given the inevitable comparisons to the U.S. equity market, 2013 has made people who diligently manage risk and broadly diversify look a bit silly. As one example, hedge fund managers, considered some of the best and brightest, dramatically underperformed on average in 2013. They did not suddenly become stupid or unskilled. To the contrary, their attentiveness during 2013 to the full scope of market circumstances and their risks is serious food for thought.

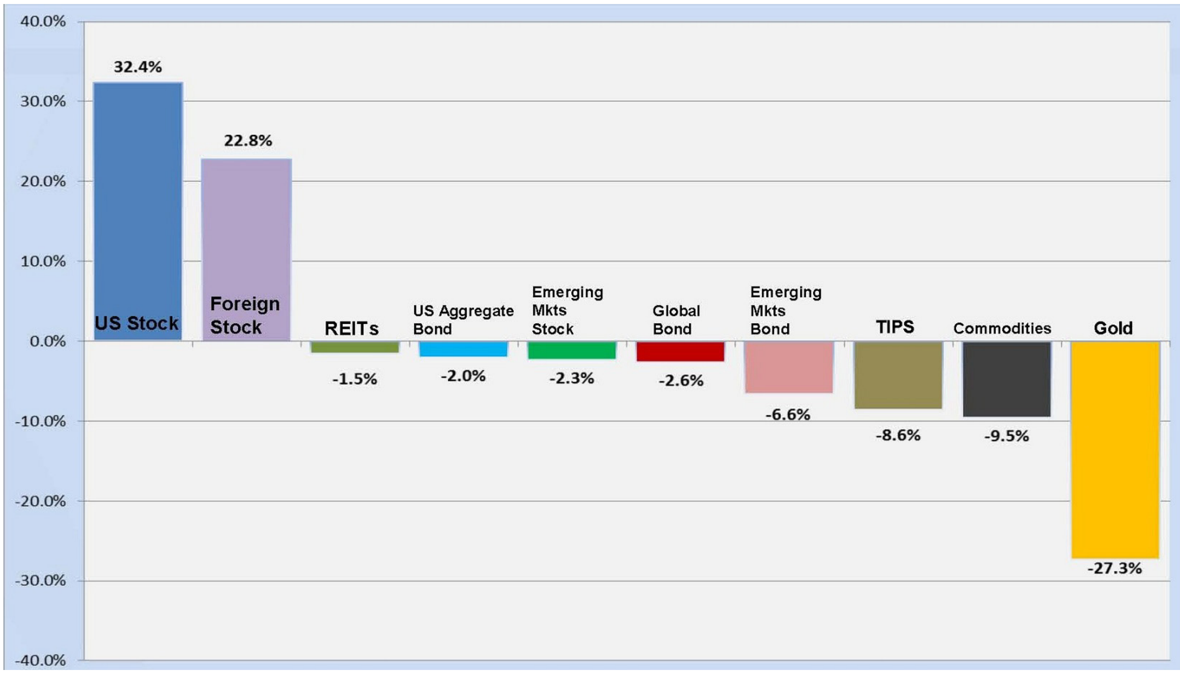
The Big Picture

- Missed opportunities? - Given the rather startling 2013 rise in the U.S. equity market, some Core model investors may be feeling that they have "missed it".

    - A look back at recent market history would suggest they have not necessarily missed anything. The domestic equity market ran up sharply in the late 1990's before the bear market of 2000-2002 wiped out more than three years of gains. From 2003 to 2007 the market surged again, reaching fresh all time highs, and again it plummeted, wiping out more than 100% of the gains off the 2002 low [see our 1st Quarter, 2013 commentary]. The math of bear markets is brutal – even if the market could run another 25% from here before the next bear (which always comes), an average bear of -34% would eradicate all of the new gains plus over two-thirds of those from 2013; and if the market gained only another 14% before the bear, it would wipe out 2013 entirely.

    - From another perspective, the Core's largest allocation was U.S. equities. That segment of the portfolio participated handsomely in the market's rise. In a very difficult year for most other asset classes, this helped offset declines in other parts of the portfolio, one of the goals of effective diversification. Not everything in a diversified portfolio is designed to work on the same cycle, and other components of the portfolio have significant upside potential in other time frames moving forward.

- Frames of reference – Core performance looks unequivocally poor for 2013 from the perspective of the U.S. equity market. Viewed from a fuller perspective of the world's financial markets, it looks quite different.



In any given year, and sometimes over longer periods, isolated comparisons with the U.S. equity market can make us look alternately very good and very bad. Neither is necessarily an accurate portrayal of how we are positioned for the longer term outlook.

Recap - 2013

For context, let us first step back a bit. As the global central banks' responses to the aftermath of the credit crisis became more and more clear, it was also clear that we were dealing with structural changes in the investment markets – that massive and repeated central bank interventions and the resulting cross currents of global capital flows and other macroeconomic conditions made it virtually impossible to make reliable shorter term assessments. By 2011, we concluded that the most reliable approach to growth without excessive risk was to position the portfolio across a number of diverse investment themes we deemed likely to play out effectively over a period of years, knowing they would need to individually weather some rough periods along the way. Results in 2012 were very solid, achieving strong portfolio gains while balancing risk.

Moving into 2013, despite the very significant risks, we felt it reasonable to anticipate that the Fed's quantitative easing program, and an even more shockingly aggressive program launched in Japan, could push prices higher in a number of asset classes, including U.S. and emerging markets equities, gold and certain commodities. The primary focus of the portfolio was equities (56.5%). Relative to the U.S. share of global equities, we significantly overweighted U.S. equities (which we considered still reasonably priced and the most reliable of the world's equity markets). We also moderately overweighted emerging markets (which we considered a better value with higher long term growth prospects). When it became clear by early 2nd quarter that capital flows in 2013 were moving heavily out of emerging markets into the U.S., we responded by reducing our emerging markets exposure, shifting a higher concentration of assets to the U.S. This worked well; for the year, the performance of our U.S. equity segment was excellent. Late in the year, as valuations became stretched and certain equity sectors showed weakness, we took selective profits, capturing some significant gains. When the U.S. market ultimately resumed its upward progress, we found a good value opportunity in homebuilders and temporarily deployed some of our cash to that sector, but are watching closely for any reaction to rising interest rates.

As one could guess from the chart above, not only did emerging markets positions suffer during 2013 - grains and gold were impacted as well. As we have commented many times, we regard gold as a uniquely important long term store of value in a world of unprecedented money printing and likely currency debasement; in response to severe price declines based on factors we consider temporary, we did reduce the position in two increments for defensive purposes, but we retained a significant allocation. Alternatively, we used persistent price weakness as an opportunity to expand our grains position, seeking to build value for the longer term.

While disappointing in the short run, these and other out of favor areas provide opportunity for significant gains moving forward. The reality is that we continue to be soundly positioned over the time frame we have envisioned. We didn't do everything right 2013– that rarely happens – but our process is not broken. We continued to analyze and learn, but, very importantly, we did not undermine the principles that got us here.

Current Outlook - 2014

The general consensus is that the U.S. market could continue to move up in 2014, but expectations are muted, with commentators generally anticipating single digit gains. Valuations are becoming quite stretched, so a lot would seem to depend upon earnings [see our 3rd Quarter, 2013 commentary]. Given this outlook, there would seem to be a greater likelihood of (a) larger relative gains from other asset classes, and (b) a surprise of some type, which could push domestic equity markets sharply in either direction. Regardless of the direction, an effectively diversified portfolio provides a better multi-year risk/reward profile than a portfolio overly concentrated in U.S. stocks, offering greater downside protection along with attractive growth potential from some of its more recently out of favor asset classes.

From a big picture perspective, we have two very profound concerns:

- Systemic Uncertainty – With the economy gradually improving and the U.S. equity market in a long winning streak, we all want to believe things are working out. But there is not a sliver of certainty. As a nation, as a world, we have never been where we are today. That much cannot be credibly debated.

  Over the past few years, we have entered the latest act in a now 15+ year drama. The risk set we face today is not isolated; with each global financial upheaval dating to 1998, the Fed has expanded upon attempts to mitigate the consequences, effectively upping the ante each time. By the time the world's financial system nearly seized in 2008, the Fed and other central banks had essentially run out of tools to fix the problems, so they began to simply swallow them whole, one huge gulp at a time – and are hoping against hope something will spur sufficient economic growth to digest them before so much debt is consumed that the "body" simply explodes.

  With respect for the genuineness of the efforts by Fed governors in the face of this overwhelming task, they are now clearly in a land they do not recognize and are not at all sure how to navigate:

  > *In an April, 2013 interview on CNBC, St. Louis Fed President James Bullard said, "We are taking risk. We are getting deeper and deeper into the woods …" (Since that statement, the Fed has spent at least another $680 billion dollars on asset purchases – the means of payment essentially drawn out of thin air). In a November CNBC interview, Atlanta Fed President Dennis Lockhart, when pressed on the question of what would alert the Fed that the bond market was on the verge of "revolting", potentially sending the whole financial system into upheaval: "I'm one who works from his gut." (In the same interview, he used the terms "never been here", "unknowable", "unintended consequences", "experiment", and "hunch".) In a December speech, New York Fed President William Dudley said, "We don't understand how large-scale asset purchase programs work to ease financial market conditions."*

  Somehow, none of this is particularly comforting. None of us wants to believe this, but the people who have designed and implemented quantitative easing do not know what's going to happen; none of us do - we simply ***DON'T KNOW***. It's an ***experiment*** born of desperation. There is no prior experience with anything nearly equivalent to this on a global scale.

Could it conceivably work? Yes – experiments sometimes do, but I don't think one could make a compelling case that the probability is high in this case. It will have to defy all kinds of conventional wisdom. It's fair to speculate that Columbus on his first voyage across the Atlantic had more reason to believe he knew where he would arrive … and he was wrong. Though he was disappointed, he at least found habitable land and natural resources. Hopefully, we will be as lucky.

Some will argue that risk is always present – the market "climbs a wall of worry". That is true, but not all risks are the same. One must always ask, "In this case, what is the cost of being wrong?" Given the magnitude of the issues in play and the degree to which the effects are unknown, it could be considerable.

- An Unconvincing Complacency – Almost everywhere we look, financial commentators speak "knowingly" about why this market should continue to run in 2014, but probably not more than 7-9% – and how it will correct at some point, but not too much – maybe 10% or so. It all sounds so innocuous. But beneath the outward confidence, all have memories of what has happened and all, presumably, an uneasy awareness of the risk. At the end of the day, you sense they all have one eye on the door. Our concern is that, with U.S. equity valuations already at high historical levels and professional investors on alert, the average retail investor is being lured by recent market gains into a more and more dangerous portfolio imbalance.

In such circumstances as these, meaningful diversification can ultimately prove crucial.

The Rest of the Journey

Since 1998, we have been on a journey through what one could reasonably call an investment wilderness. We've weathered, already, two "once in a lifetime" market cataclysms. In both instances, we recognized well in advance the magnitude of the risk, though we could not predict the timing of the ultimate event, and we took our investors off the beaten path in an effort to reduce the danger without abandoning the journey.

At this stage, I wish it were different, but Dorothy, we're not in Kansas anymore. There may not be witches and flying monkeys, but there are strange and frightening things in this new place to which we have been transported. In this case, they are not fantasy – they are very real - and, through no fault of his or her own, the average investor is no better equipped to comprehend them than the casual student of physics is equipped to fully comprehend the curvature of space-time.

Unlike 2000 and 2008, this is not a prediction – the issues and concerns today are not the same as the concerns heading into 2000. It is an admonition to recognize that the risk this time is greater than before, but it is also far more complex. Thus, its outcome more unpredictable and subject to a vast range of possibilities. So again, we have taken an alternate route in an effort to skirt the most dangerous risks, but we continue the journey.

Are there positives in the mix? There absolutely are. I hope to devote some detailed attention to them in a later commentary. Some of them are potentially game changing. But it would be irresponsible to invest without considering the magnitude of the embedded risks.

Respecting what we do not know – what is not fully knowable – we refuse to pretend with your money that we are on an everyday stroll through the investment landscape, though the sun may currently be shining. This journey is not close to over, and for most, there is much at stake. Throughout, our commitment to you is to seek diligently for insight, proceed with due care, and invest with uncompromising intellectual integrity.