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"*You don't know who is swimming naked until the tide goes out.*"

Warren Buffett, circa the 2008 financial crisis

Dear Friends,

Beyond being a timely quote for summer, when it comes to the frequency with which this letter has hit your mailbox, the tide has gone out and we seem to have forgotten our swimsuits. The last letter we *penned* to you dates back to January of 2011. While it was a Jim Dandy calling for further room for appreciation in stocks (outcome: +54% on the S&P before dividends), over three years is a long time to sit on our laurels. Especially when in the buff. Your patience is much appreciated!

Bookends

On the occasion we write, we have found it helpful to have something insightful to say. In this regard, we are grateful for excesses of all descriptions. Today we are blessed with excessive excesses. In most respects, we are near the opposite extreme of where we were in early 2009 and again in 2011. At that time we listed seven considerations around which we built our bullish thesis amidst structural problems, a stubborn economy and excessive pessimism. We summed it up thusly:

> "*We humans are programmed to be optimistic at tops (that's how bubbles are built) and despair at the lows, a phenomenon which inevitably leads to doing exactly the opposite of what we rationally should be doing at the time. The best way to overcome this bias we know is to stick with the Golden Rule of Investing which reads: The value of an asset over time is highly correlated to its earnings and the growth rate therein.*"

In 2011 stocks were still trading cheaply in relation to recovering earnings. Profit margins were about to hit record levels. Earnings growth was set to accelerate further. Let's call this picture our left hand bookend.

Roll forward to the summer of 2014. The Wall Street Journal's keeper of statistics, Mark Hurlbert, recently wrote a cautionary article entitled *How Overvalued Markets Translate Into Lower Returns.* While noting that overvalued markets can persist for an extended period, Hurlbert developed a thesis based upon the market's valuations at past bull market peaks (there have been 35 of them since 1900). He stated, "Five of the six relatively common valuation ratios show the market is more overvalued today than it was at between 82% and 89% of those peaks (emphasis ours)."

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In describing the sixth and least cautionary indicator (price/earnings ratio), Hurlbert stated this measure is “the one which paints the least bearish picture…but still shows the market to be more overvalued than it was at 69% of those past market peaks.” He wraps up his thesis thusly: “the chief point for investors is simply this. The stock market isn’t poised to produce returns that are in line with even its long term annualized average of around 10%, much less the 20%+ returns we have seen in recent years.”

It is Hurlbert’s postulate which we believe provides the right hand bookend: our matched pair. Calling market tops is a fool’s errand, a task we decline to take on. Our message to you is the relationship between risk and reward has evolved meaningfully. And not in our favor. While staying invested in holdings which measure up well, where appropriate we are moving to dial down risk. Cautious asset allocation and emphasizing what we consider to be defensive stocks is the order of the day.

Chernobyl

Now there was a doozy of an environmental problem. Economies can have environmental problems as well. We would like to devote a few paragraphs to describe some environmental problems businesses face, in particular for publicly traded companies. Our purpose in delving into this space is that a poor climate for companies will be impactful on profitability which, in turn, will be a depressant to price. Effectively, this constitutes a secondary form of capital risk, especially when companies are currently enjoying high valuations by historic standards. In other words, regardless of source, best to avoid portfolio meltdowns. A few examples:

- Federal Reserve interest rate policy of lower-for-longer is an issue. This “juicing” of capital is the functional equivalent of steroids. May help short term performance but at the cost of long term health. It is clear that these near zero rates have favorably impacted capital assets to include stocks, bonds and real estate. When rates move up, it is fair to expect these misallocated, interest rate subsidized assets to suffer in price.
- Pensions ranging from Social Security to a local police/fire/teachers’ fund are chronically under funded. Watch Detroit and Chicago for illustration. A combination of benefit cuts and higher taxes is the most likely outcome. The magnitude of this problem coupled with other entitlement programs such as Medicare is chronic and virtually incalculable. Higher taxes translate to lower earnings for corporations and individuals as well as reduced consumption for those whose benefits are cut.
- Regulations are being promulgated by government at record rates. Above the costs of compliance are basic economic issues. For example, Seattle voted a minimum wage of $15 an hour on a relatively short phase in basis. This roughly 75% increase in labor costs will be material to businesses which hire people entering the economy. Governments have a new tax in mind on carbon emissions which, while designed to be helpful to the environment, will spill over into all aspects of the economy in ways which are hard to predict. Finally, our favorite, the Keystone Pipeline. Lower energy costs and avoiding sending $$$ to the Middle East would seem to make this a no brainer, at least from a purely economic standpoint. But for regulation and politics. You get our point. A deteriorating environment in which to do business will eventually show up in price.

We can see the result of heavy handed treatment of companies by comparing France to the US. France, as you may know, is not the easiest place in the world in which to do business. If a factory needs to be closed for whatever the reason, be prepared to spend much time applying for permission and a great deal of money to accomplish the task. A few years ago, in an effort to address high unemployment, France enacted a mandatory 35-hour work week. The concept was businesses would be forced to hire more people. Result? Unemployment actually ticked up as some businesses closed. As these whacky policies relate to stocks, in its current issue Barrons compares France’s leading telecom to the two

leaders in the USA. Our companies sell at nearly a 50% higher valuation to earnings than does France's #1 telecom. To the extent the US ventures down this sorry road, it would be fair to expect that profitability will suffer and with it the taxes that governments collect as well as the returns shareholders earn. The proverbial lose/lose proposition.

On that cheery note, the handful of you who encouraged us to resume letter writing are probably wishing we would use the balance of the summer to wade back into the water and keep our thoughts to ourselves. We simply want you to know what we are thinking and what that means as it relates to your investments. We are thrilled with the results achieved in recent years and expect you will give us a call if you have any questions.

Over the years we have closed our summer letter with a recommendation as it relates to vacationing. This year is a great time to splurge, ridiculous airfares and all. However, we would prefer that you do not put a non-refundable deposit on that ocean front villa for next year. Continue to hoard your airline miles for use in leaner times. Don't forget to pack your swimsuits. Warren may be on the beach with you!