Q1 2016 Market Review & Outlook

Morgan Creek Capital Management

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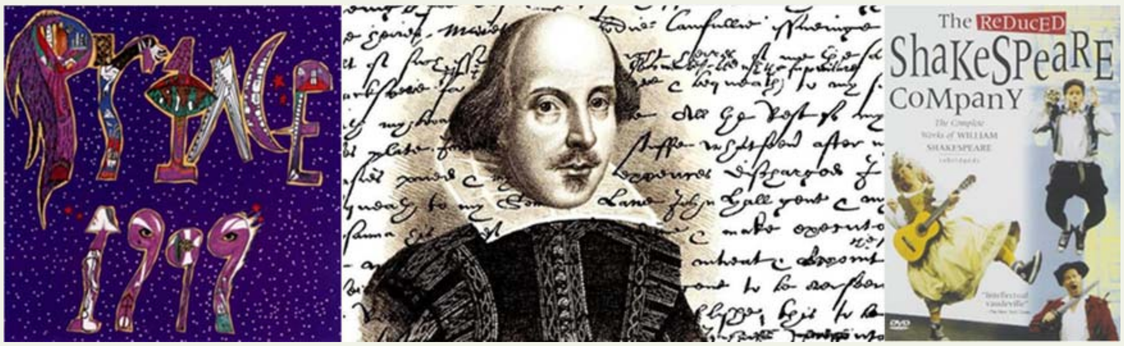
Letter to Fellow Investors

Two Thousand Zero Zero, Party Over, Oops, Out of Time…



Source(s): Allmusic.com, Telegraph.co.uk, Amazon.com

In April, nearly 400 years to the day after Shakespeare died, we lost another truly remarkable artist, Prince. In his career, Prince sold more than 100 million records, won seven Grammy Awards, a Golden Globe and an Academy Award. Prince was recognized by Rolling Stone magazine as the 27th most influential artist of the Rock Era and he was inducted into the Rock & Roll Hall of Fame in 2004. Prince Rogers Nelson was born in 1958 in Minnesota and grew up in a musical household where both parents were jazz performers. He was named after his father who performed under the stage name, Prince Rogers. His early life was not easy and his parents' separation when he was ten forced him to bounce around homes of family and friends. Skipper (as he was called in his youth) chose to immerse himself in the Minnesota music scene and rose quickly through the ranks, signing with Warner Brothers records at age 18 and releasing his first album, *For You* a year later in 1978. Astonishingly, Prince wrote, arranged and produced all the songs on the album and played all 27 instruments used on the record. The debut record met limited commercial success but Prince got a big break in holding his band's first concert at the iconic Capri Theatre in January 1979. In October of that year he released his sophomore effort, the eponymous *Prince,* which shot to #4 on the R&B charts, #22 on the Billboard 200 chart and eventually went platinum. Prince was a great showman and fomented controversy with his sexual lyrics, outrageous clothing and makeup and his truly non-traditional sound. Famed music critic Stephen Thomas Erlewine described Prince's album *Dirty Mind* as "a stunning, audacious amalgam of funk, new wave, R&B, and pop, fueled by grinningly salacious sex and the desire to shock" and his fame grew rapidly in the early 1980s. In 1982, Prince formed the band The Revolution and released the double album titled *1999,* which sold over three million copies (and gave us the lyrics that are the title of this letter). The video for "Little Red Corvette" helped break the color barrier on MTV along with Michael Jackson's "Billie Jean." Prince was alternative before it was really cool to be alternative and his career began to accelerate, leading to the production of the loosely autobiographical movie *Purple Rain* (in which he starred) and the album of the same name as the soundtrack. The movie and album were monster hits. Prince won an Oscar for his original score (I will concur that the movie was amazing as it was my first date with Stacey) and the album spent 24 weeks atop the Billboard 200 chart. At one point in 1984, the movie, the single and the album were number one, making Prince the first artist to accomplish that achievement. It is interesting that two of the other songs that came from the *Purple Rain* album were "*When Doves Cry"* and *"Let's Go Crazy"* as those themes will play a role throughout the letter.

Prince was red hot in the mid-eighties and began to produce content at a breakneck pace. *Around the World in a Day* was released in 1985, and was followed by an announcement that Prince would no longer do live performances and music videos so he could focus on his studio work. Over the course of the next year, tensions in the band began to emerge, and in 1986 The Revolution disbanded and Prince went into overdrive on the production front. A rift occurred with Warner Brothers over the release of *Sign o' the Times* as Prince wanted to release a triple album and the label forced him to trim it back to a double album. Prince did a large number of collaborations with other artists during this period including Madonna and Sheena Easton and produced his fourth film, *Graffiti Bridge,* which flopped at the box office. Prince formed a new band, The New Power Generation and went back on tour. In 1992 he released his iconic *Love Symbol* album with the unpronounceable symbol ( ) (combining the male (♂) and female (♀) signs that would eventually become his name) that included one of the most autobiographical lyrics ever, ***"My name is Prince and I am funky, My name is Prince the one and only."*** In 1993, as a means of rebelling against Warner Brothers for not releasing his work quickly enough, Prince changed his name to the Love Symbol and became the Artist Formerly Known as Prince. The discord grew and in 1996, the Artist released *Chaos and Disorder* (perhaps another theme for this letter) and finally split with the label and released *Emancipation* in early 1997 in celebration of his new freedom. The 36 song, three CD set was a tour de force and went platinum and (to outdo himself) he followed that with a five CD collection of unreleased material in 1998 entitled *Crystal Ball* (so many investment themes). In 2000, the Artist went back to being called Prince and the rest, as they say, is music history.

Anyone who is a music fan mourns the loss of Prince's musical genius. Those of us who are Prince fans know the power of his lyrics and we can relate to some of his most beloved songs today. ***"How can you just leave me standing? Alone in a world that's so cold... Why do we scream at each other? This is what it sounds like, when doves cry."*** Those of us in the investment business might also think about those same lyrics every time we think about how Ms. Yellen and the Fed will get out of the fine mess they have made (more on that below). In thinking about the Fed (and all global Central Banks for that matter), one can't help but call to mind lyrics from "Let's Go Crazy", ***"Dearly beloved we are gathered here today to get through this thing called life. Electric word life, it means forever and that's a mighty long time… So when you call up that shrink in Beverly Hills, you know the one, Dr. Everything'll Be Alright… Dr. Everything'll be alright will make everything go wrong."*** If we gave QEeen Janet a chance to defend herself and offer her perspective on the current situation, she might channel some "Purple Rain" and tell us that she really means well and she knows what is best for us. ***"I never meant to cause you any sorrow. I never meant to cause you any pain. I only want to see you laughing in the purple rain… Honey I know, I know, I know times are changing, it's time we all reach out for something new, that means you too. You say you want a leader, but you can't seem to make up your mind. I think you better close it and let me guide you to the purple rain."*** There are others who might turn to a song from *Graffiti Bridge* and respond back with a lyric from "Thieves in the Temple" (that again could be a letter theme) when thinking about what might happen when QE really ends, ***"I feel like I'm looking for my soul, like a poor man looking for gold, there are thieves in the temple tonight."*** Two days after Prince passed away was the 400th anniversary of Shakespeare's passing, I got inspired, and writing about Prince and the Bard seemed natural.

A couple of weeks ago I was in London meeting with managers. Walking to one of the meetings, I passed by the Criterion Theatre in London, the home of the Reduced Shakespeare Company, where for nine years RSC performed *The Complete Works of William Shakespeare [Abridged]* (I was lucky enough to see it there multiple times). All 37 Plays in 97 minutes performed by three actors. It is a whirlwind, improvisational, uproariously funny experience and one of the best theatre experiences I have ever had. The play has become one of the world's most popular shows, touring all around the world with different troupes. The actors start the show by introducing themselves and do a short biography of Shakespeare, which they mistakenly confuse with parts of a biography of Adolph Hitler. They begin the production with a series of brief parodies with *Romeo and Juliet* first, followed by *Titus Andronicus* (as a cooking show), followed by *Othello* performed as a rap song. All the comedies are then combined into one convoluted reading because, as the actors tell the audience, "all the plots are recycled anyway." Next they combine all the histories (King John, Richard II, Richard III, Henry IV, etc.) into a single production that is performed as an American football game. *Julius Caesar* is reduced to just his death, followed immediately by a reduction of *Antony and Cleopatra* and *Macbeth* as a single duel performed with bad Scottish accents. The actors discuss that they forgot to perform *Coriolanus,* which one of the actors says he will not perform due to the vulgarity of the title, and *Hamlet.* The same actor says he is too afraid of performing Shakespeare's greatest work, so he runs out of the theatre chased by one of the other actors. To try and stall, the sole remaining actor improvises by playing the *William Tell Overture* on his throat and eating fire before calling intermission. The entire second act is focused on performing *Hamlet.* They actually perform *Hamlet* multiple times, including once where they involve the audience in the Ophelia *"get thee to a nunnery"* scene. The actors decide to try and perform the play faster each time (fastest being 42 seconds) and do the last performance (in 43 seconds) backwards including comedic satanic messages harkening back to playing the Beatles album backwards to hear the Devil. Prince sang, ***"Will you wander the wilderness, searching for a King? Will you settle for a Prince and a sea of everything?"*** We will indeed embrace a Prince and look to the complete works of William Shakespeare for a sea of everything that we can apply to investing. So here is some wisdom from all 37 plays, but alas, we only do *Hamlet* once (and not backwards).

Shakespeare on Investing

"Wisely and slow; they stumble that run fast." *(Romeo and Juliet)* All throughout history we have heard of the triumph of the tortoise over the hare and the mantra that slow and steady wins the race. Shakespeare reminds us of this wisdom and we contend that this mantra is one of the most critical elements of successful investing. Executing a consistent investment plan and process over time is the key to wealth preservation and growth, and we believe that lower volatility strategies (avoiding the stumbles) will generate the highest long-term returns. Higher volatility investments (those that run fast) will have short bursts of outstanding performance, but tend to experience higher frequency and severity of downturns. The mathematics of loss is not kind to the hares. If you lose (10%), you have to make 11% to get even; lose (20%), you have to make 25%; lose (50%) and you have to make 100% just to get your capital back. Investing in a low volatility strategy requires patience, and Shakespeare had some thoughts on that as well. ***"What cannot be preserved when fortune takes, Patience her injury a mockery makes?"*** *(Othello)* Great investors understand the value of patience and follow a disciplined approach. They stay the course, even when going through difficult periods (when fortune takes) and redouble their efforts to remain disciplined when the strategy is out of favor. Great investors know that good strategies (and good investments) will play out well. When the only thing that has changed is the price of an investment, it is time to increase the position, not sell it, and patience will be rewarded over time as the price comes back to reflect the true underlying value. Patience is also necessary in executing long-term focused investment approaches like the Endowment Model. ***"Well, God give them wisdom that have it; and those that are fools, let them use their talents."*** *(Twelfth Night)* The gifts of wisdom, insight and perspective come from accumulated experience, diligence and plain old hard work. Those that chose the easy (foolish) path to riches, get what they deserve. This preference for the easy path is why the average investor underperforms the averages (and the Endowments) by such a large margin. The real challenge is that long time horizon investment strategies are not exciting. ***"Life is as tedious as a twice-told tale, vexing the dull ear of a drowsy man."*** *(King John)* Good investing is boring. Paul Samuelson said, "Investing should be more like watching paint dry or watching grass grow. If you want excitement, take $800 and go to Las Vegas." George Soros also has a view on the excitement of investing, saying "If investing is entertaining, if you're having fun, you're probably not making any money." In the spirit of this letter, if you want entertainment, go to the theatre. ***"Things sweet to taste prove in digestion sour."*** *(Richard II)* It is a general rule (with some exceptions) that what is good for you tastes bad and what is bad for you tastes good. The same rule applies to investing. When you make an investment that makes you feel good (sweet to taste), you will likely lose money (sour in digestion). Conversely, when you make an investment and you feel badly (sour to taste), you will likely make money (sweet in digestion). I used to say that a great investment advisor's job was to maximize the discomfort of the client/board by constantly making good but difficult decisions that make you sick to your stomach, but then I realized that if you maximize discomfort, they get rid of you because you are an irritant. So the real trick is to optimize their discomfort, keep them uncomfortable enough to make good investments, but not so uncomfortable that they fire you. In other words, slip a little sugar in with the vegetables every now and again. Another area where comfort is a problem is fees. ***"But the comfort is, you shall be called to no more payments, fear no more tavern-bills."*** *(Cymbeline)* The jailor says to the prisoner to look on the bright side that he no longer has to pay his bar tab, but we would say that is a bad trade. Applying the same logic to the markets, if a stock you own falls a lot, not having to pay taxes also seems like a bad trade. We believe that paying taxes (and incentive fees) is a good thing, because it means you have gains. Contrary to the cult of Bogleization, you want to maximize fees in investing (not minimize them) so long as the bulk of them are incentive based. In what business does the best person charge the least? ***"You pay a great deal too dear for what's given freely."*** *(Winter's Tale)* You always get what you pay for, free advice is usually very costly, and free money is more costly still. When all companies are propped up by abundant credit, value destructive behavior will occur and the price paid later will be much higher than anticipated. Never invest on a stock tip and be wary of investment opportunities where the fees are below average, as you must ask yourself why would someone charge below market rates for their expertise? Groucho Marx famously quipped, "I would never join a club that would take me." The best managers don't need (or even want) your money and gaining access to them is priceless (like buying them when they have their second worst quarter ever in Q1). So on the subject of investing, a simple summation. ***"No profit grows where is no pleasure ta'en."*** *(Taming of the Shrew)* Shakespeare is imploring us to always love what we do as there is little to be gained in partaking in things we have no interest in. What I love most about the investment business is that it is constantly changing, evolving and is something that can be engaged in for an entire lifetime. That said, the very best part is that you actually get better (contrary to many endeavors) as you get older and wiser (where wisdom is defined as learning from mistakes). As my manager friend Bill Duhamel says, "With every investment we get richer or wiser, never both."

Shakespeare on Process

"Hasty marriage seldom proveth well." *(Henry VI, part 3)* Love takes time and so does good investing. You have to really do the work (get to know the other person) before you invest in a life-long relationship, and usually when short cuts are taken, short marriages are made. When investing you also have to do the work (get to know the manager or the company) and hasty investment decisions (lust more than love) do indeed seldom proveth well. ***"Strong reasons make strong actions."*** *(King John)* How does one create strong reasons? Do the work. In investing, due diligence is a continual endeavor. Constantly forming hypotheses, gathering data, testing the hypotheses and making investment decisions is a critical discipline that improves through repetition. In the same way that exercise strengthens the muscles and leads to strong physical actions, formation of strong reasons (investment theses) leads to strong intellectual actions. ***"Is not this a lamentable thing, that of the skin of an innocent lamb should be made parchment? That parchment, being scribbled o'er, should undo a man?"*** *(Henry VI, part 2)* In investing, details matter and many investment outcomes will be determined by the skill of the drafters of the binding documents. Fortunes have been lost for how a particular term of an agreement was set forth in a contract, so pay attention to the documents and always dot the I's and cross the T's. That said, Shakespeare had a sense of humor. ***"The first thing we do, let's kill all the lawyers."*** *(Henry VI, part 2)* Once again, well-worn sentiment traces its roots all the way back to the Bard. Sadly, the negative feelings toward lawyers go back a long way. Funny, I always thought the joke "what do you call forty lawyers on the bottom of the ocean? A good start" had no literary credibility until now. But, let's get back to process. ***"Beware instinct. The lion will not touch the true Prince. Instinct is a great matter."*** *(Henry V)* Instinct is an incredibly powerful thing. Even a savage predator like a lion has an internal sense that guides him away from attacking a Prince (or so the superstition went in Shakespeare's time). Michael Steinhardt, who was one of the greatest investors of our time, always trusted his intuition (another term for instinct) and described it as, "more than just a hunch, intuition resembles a hidden supercomputer in the mind that you're not even aware is there. It can help you do the right thing at the right time if you give it a chance. In fact, over time your own trading experience will help develop your intuition so that major pitfalls can be avoided." Learning from your mistakes creates the intuition and explains why most of the greatest investors that we talk about today are more senior, experienced, individuals (many who are still knocking the ball out of the park in their 80s). Another important point Steinhardt makes is that intuition allows you to make good decisions even when you don't have complete information (which you never will). Intuition also helps you know which facts are most important. ***"Now is the winter of our discontent made glorious summer by this sun of York; and all the clouds that lour'd upon our house in the deep bosom of the ocean buried."*** *(Richard III)* The lesson here is not to celebrate your victories so much that you let your guard down. King Richard thinks his side has won the war, but in relaxing their defenses, their family line ends up being eliminated (by a series of executions) by King Henry VII. In investing, even the best investment outcome is not permanent (there are plenty of stories of great wins turning into great losses) and just when you think you have the golden touch and get careless with your discipline and process, you will lose that winning streak faster than you can count to VII. ***"Love is blind and lovers cannot see the pretty follies that themselves commit"*** *(The Merchant of Venice)* When you are in love, you lose objectivity and can't see how foolish you might appear at times when you are completely entranced. Investors fall in love with investments all the time and it can be an extremely expensive mistake. There are myriad examples of mistakes that come from that loss of objectivity (too many to list here) but suffice it to say that whenever you violate one of your fundamental investment rules because *"this one is special,"* it is folly, and will likely lead to pain in the future.

Shakespeare on Mistakes

"Sweet are the uses of adversity, which, like the toad, ugly and venomous, wears yet a precious jewel in his head; And this our life, exempt from public haunt, finds tongues in trees, books in the running brooks, sermons in stones, and good in every thing." *(As You Like It)* Nietzsche said, "That which does not kill us makes us stronger." In essence, adversity can be used as a tool to improve ourselves after the fact. One key to success in this regard is to spend time in reflection on the event in order to truly learn from our mistakes. What better place to spend time in solitude and contemplation than nature where we can find good lessons in everything under the sun? ***"Let me embrace thee, sour adversity, for wise men say it is the wisest course."*** *(Henry VI, part 3)* Shakespeare embraces the "that which does not kill us" theme for King Henry, as he acknowledges the wisdom from the sages. The benefit is not simply in surviving our mistakes, but actually learning from them and becoming better investors. The only way to learn is to fully embrace the adversity, no matter how sour, and study why an outcome occurred the way that it did and what decisions led that particular circumstance. In investing, you will get to use this quote a lot, because you will be wrong a lot. The legends are only right 58% of the time, and the better you get at analyzing the root cause of mistakes and enhancing your process to avoid that mistake in the future, the better your returns will be. Keith Krach (the former CEO of Arriba and current CEO of DocuSign) says that he thinks it is great to learn from OPE (Other People's Experience) and I agree with the point wholeheartedly (particularly when applied to mentors) for just about everything except investing. I have found over time that in investing you really only learn from your own mistakes. You need to feel the pain of loss in your gut in order to make necessary changes. You just don't get the same impact hearing about other people's mistakes and subsequent losses. ***"And oftentimes excusing of a fault doth make the fault the worse by the excuse."*** *(King John)* We all make mistakes, and in investing, we will make lots and lots of mistakes (remember the best of the best are wrong 42% of the time). The best thing you can do when you make a mistake is to admit it and cut your losses. There will always be an urge to rationalize the mistake and make excuses for why it happened. Resist the urge because the excuse just makes it worse. Dean Smith said it very succinctly, RALF your mistakes; Recognize, Admit, Learn, Forget. ***"What's gone and what's past help should be past grief."*** *(Winter's Tale)* Great investors don't spend precious resources grieving over what didn't go well in the past. ***"To mourn a mischief that is past and gone, is the next way to draw new mischief on."*** *(Othello)* The wisdom of this passage applies not only to mischief, but also to investing. Lamenting poor past performance won't actually help and is actually more likely to bring on more poor performance if the lamentation triggers an investment decision based simply on the performance (as opposed to legitimate concerns about changes to People, Process or Philosophy). ***"How poor are they that have not patience! What wound did ever heal but by degrees?"*** *(Othello)* The old saw that time heals all wounds (primarily related to affairs of the heart) perhaps has its roots in this quote, but the wisdom for investors is the same: patience is a virtue. In investing you must stay the course with your strategic plan, and while there will always be tactical shifts within the long-term strategy, the real test comes when there is a period of underperformance (the wound). Wounds don't heal overnight and when investors lose patience and reflexively jump to a new strategy, they are more likely to be injured again and end up even worse off. The mantra for the P90X workout system sums up the essence of this quote, Decide, Commit, Succeed. Decide on your strategy, work at it (even though it will be hard); Commit to seeing it through (just when you want to quit, like the average P90X user at day 17); and have the patience to see it through for the full period and you will Succeed. ***"Wise men ne'er sit and wail their loss but cheerily seek how to redress their harms."*** *(Henry VI, part 3)* Like wise men, the best investors don't agonize over any single loss, they learn from the individual experience and, better yet, look to the entire portfolio for means of filling the void left by the loss. Rookie investors think they have to make the money back the same way they lost it and hold "dead money" positions rather than sell the losers and redeploy the capital in to a better idea. All along I thought Coach K was responsible for the wisdom that what differentiates the great player (investor) from the average player is that the average player focuses on the last play (wails their loss), while the great player focuses on the next play (cheerily seeks to redress their harms), but it was Shakespeare.

Shakespeare on Fear

"Of all base passions, fear is the most accursed." *(Henry VI, part 1)* Caution is a good thing, but when it gives way to fear, that is not such a good thing, particularly in investing. Fear is a paralyzing emotion that causes us to stop making good decisions, and when we stop making decisions, we cease being investors. Investing is quite simply the business of taking intelligent risk, not avoiding all risks. Therefore keeping fear in check so that we keep making investment decisions is critical. One of my early bosses coined a great line (so great they put it on coffee mugs), *"Invest without Emotion"*, and while that is a noble (and quite difficult) goal, Shakespeare would have us reduce the list of prohibited emotions to one, fear. That said, fearlessness does not imply recklessness and does not diminish the importance of preparing in advance of making decisions by evaluating potential outcomes, analyzing risk/return tradeoffs and developing contingency plans to manage the position when the inevitable changes to the environment occur that will attempt to unleash the fear again, tempting us to make suboptimal decisions. ***"Our doubts are traitors, and make us lose the good we oft might win, by fearing to attempt."*** *(Measure for Measure)* Exploring new ideas and strategies is one of the keys to success in any endeavor and it is critical not to let your doubts stop you from acting. While a modicum of self-doubt and humility is a good thing, allowing doubt to turn to paralyzing fear is extremely costly. Action is one of the most powerful edges in investing. If you make a mistake (which happens frequently even to the best investors), you can admit the mistake and correct it before it results in irreparable harm, but if you don't act for fear of losing, you can't win. ***"Cowards die many times before their deaths; the valiant never taste of death but once."*** *(Julius Caesar)* Simply translated, fortune favors the bold. To be successful, in life and in investing, you need to be courageous, not reckless, but valiant and act with conviction and not shy away from challenges. Our time on this earth is limited, make the most of it. ***"Foul-cankering rust the hidden treasure frets, but gold that's put to use more gold begets."*** *(Venus and Adonis, a poem)* Investing is about taking intelligent risks. If you take no risk, you get no return, and in some extreme cases the treasure can be lost, stolen, decay, obsolesce or be otherwise impaired if not put to good use with the intent of earning a return on that investment. ***"Omittance is no quittance."*** *(As You Like It)* A quittance is a release from an obligation or a discharge of debt. Not acting on something (in investing, perhaps an opportunity to buy or sell), does not give you an excuse if things don't go your way. Sins of omission are just as deadly as sins of commission and can be even more costly to your wealth over time because markets tend to go down much faster than they go up, so putting off that rebalancing (or stepping to the sidelines) until tomorrow can be very painful. ***"In the night, imagining some fear, how easy is a bush supposed a bear!"*** *(A Midsummer Night's Dream)* When it is nighttime and dark (lack of full information or psyche clouded by fear) everything appears dangerous and even the most harmless things can elicit fear. One solution is to stay tucked up under the covers in bed and not venture forth, but that leads to missed opportunities and no growth in your wealth. The better solution is to find a light source to illuminate the situation (research) so that you can distinguish the real threats from the imaginary ones. ***"The better part of valour is discretion."*** *(Henry IV)* Knowing when to charge and when to retreat is critical to survival in battle, and investing is no different. There are times to be aggressive in investing and times to be conservative, or even defensive. Knowing when the time is right for each strategy is the tricky part. Many a general, knight or investor who thought themselves brave found out the hard way when pressing a bad position that discretion clearly would have been the better part of valour. One nice thing about investing is that you are not forced to engage and put money at risk if you feel the environment is inhospitable. Julian Robertson was fond of saying, "Live to fight another day." Don't press bad positions; sell when you make a bad buy and cover when you make a bad short. Similarly, while it is true that you can't play poker if you don't bet your chips, you can't play at all if you lose all your chips by playing a bad hand. You can wait until that perfect hand comes along and bet big.

Shakespeare on Talent

"He hath not eat paper, as it were; he hath not drunk ink; his intellect is not replenished; he is only an animal, only sensible in the duller parts. *(Love's Labour's Lost)* Charlie Munger (Vice Chairman of Berkshire Hathaway) says, "I have met a sum total of zero successful people who do not read all the time," and Shakespeare would agree. The point here is that without education and intellectual stimulation, humans act on an animalistic level and will not have a great deal of sense. Investing is an intellectual pursuit and I have met a sum total of zero great investors who don't read all the time, but more important than the volume of the paper and ink they have eaten and drunk, is the ability to synthesize from the tremendous volume of information the insights needed to make superior investment decisions. ***"Reputation is an idle and most false imposition; oft got without merit, and lost without deserving."*** *(Othello)* One of the toughest things in investing is identifying talent and determining which standards to use when judging the quality of that talent. Sadly, the vast majority of investors still overweight recent performance when evaluating managers. Given the cyclicality and volatility of performance (even within the track records of the most proven talent), a narrow focus on recent performance will lead to myriad poor allocation (hiring and firing) decisions. The biggest challenge might be that when people try to judge skill by performance they fail to consider that the recent strong performance could have been luck and the good reputation would have been without merit. Conversely, poor recent performance could be caused by a random element of bad fortune, or worse, a temporary collective investor bias away from a particular sector, geography or style and the resulting bad reputation would be undeserved. The Yale University endowment (which exceeds nearly all other investors) provides confirmation of this idea. Yale's average investment duration with managers (which is now approaching two decades) allows for the cyclical anomalous periods to be smoothed away. So long as the People, Process and Philosophy haven't changed, then a short period of poor Performance is an insufficient reason to abandon a manager. ***"My salad days when I was green in judgment, cold in blood, to say as I said then!"*** *(Antony and Cleopatra)* Oh to return to the early times as an investor full of innocence and enthusiasm, to stay at the peak level of performance by not becoming jaded to the realities of the system that thwart price discovery and tilt the odds against the average investor. Sometimes technology changes the playing field too much, yet I might argue that unlike physical skills where longing for younger days of peak performance makes sense, in an intellectual pursuit like investing it is better to have a little age, experience and wisdom. ***"Those wounds heal ill that men do give themselves."*** *(Troilus and Cressida)* Self-inflicted wounds tend to not heal as completely as other wounds, perhaps because of the psychological baggage associated with them. In this regard, in investing, the scars from a crisis are even harder to overcome (because everyone can see things so clearly after the fact) and because they linger much longer they tend to influence decision making more than they should. This phenomenon could be likened to investors always fighting the last war. An unwillingness to deploy capital after a big loss can be a huge impediment to achieving satisfactory long-term investment results. ***"But screw your courage to the sticking place, and we'll not fail."*** *(Macbeth)* Courage comes from conviction, conviction comes from knowledge and knowledge comes from diligence and effort. Investing is such a simple game (picture the "winkyface" emoji here). ***"I'll lock thy heaven from thee. O, that men's ears should be to counsel deaf, but not to flattery!"*** *(Timon of Athens)* People want to hear good news. They don't actually like sound counsel because it may contain bad news (even when good for them) and they are seduced by flattery. The riches of heaven are available to those who can turn the table and be open to constructive counsel.

Shakespeare on Power

"Friends, Romans, countrymen, lend me your ears; I come to bury Caesar, not to praise him; The evil that men do lives after them, the good is oft interred with their bones." *(Julius Caesar)* Lord Acton (an English Catholic historian) did not mince words when he said, "absolute power corrupts absolutely," going on to further clarify that basically all great men are bad men (perhaps a little harsh, but there is plenty of evidence in his favor). While some of the powerful do indeed have good intentions, they simply never get to them (buried with best intentions), and as Saint Bernard (a French monk) paraphrased Ecclesiastes, "the road to hell is paved with good intentions." Evil is done to stay in power and perpetuate the status quo and we all must live with the consequences of those actions in the future. ***"Some rise by sin, and some by virtue fall."*** *(Measure for Measure)* Ironically, the extremes of indiscriminate virtue and vice are equally heinous in that each is motivated by self-gratification, which disregards the welfare of others. ***"O, it is excellent to have a giant's strength, but it is tyrannous to use it like a giant."*** *(Measure for Measure)* Just because you have great power from a position of authority doesn't mean you should use it at the expense of the weak. The issue here that manifests itself most in investing is the task of keeping interests aligned to check the urge for the powerful to act in a tyrannous manner. ***"If money go before, all ways do lie open."*** *(The Merry Wives of Windsor)* Money does grease the skids of commerce and people will act in their self interest in utilizing lobbying. A firm we work with, Strategas, has a Lobbying Index which creates a basket of the companies that spend the most in Washington D.C. each year and that Index has outperformed the S&P 500 for over a decade, so it appears that money is indeed a door opener (shocking, I know). ***"If thou wilt lend this money…lend it rather to thine enemy, who, if he break, thou mayst with better face exact the***

penalty." *(Merchant of Venice)* Polonius tells his son Laertes in Hamlet not to borrow or lend money, but if you really have to lend, Antonio tells Shylock to lend it to your enemy so when it comes time to get tough, you won't mind taking your penalty. It follows from the ancient wisdom to keep your friends close and your enemies closer. Money and enemies make a natural link to elections and Shakespeare had some thoughts on the perils of government. ***"What a terrible era in which idiots govern the blind."*** *(Julius Caesar)* Given the incredibly bad situation brewing in the U.S. elections this year, it is a little (very little) bit comforting to know that there is nothing new in this world and from ancient times governing has been about making promises to blind the electorate in order to keep the powerful in power even though they know the elected (the idiots) know they can't fulfill the promises.

Shakespeare on Authority

"The more pity that fools may not speak wisely what wise men do foolishly?" *(As You Like It)* In a class system, the lower class was not allowed to speak of their observations of the foolish things that supposedly wise men did. The same is true in investing. Investors (as a group) tend not to question the wise, the powerful or the elite and instead behave like a group of lemmings jumping off a cliff. There are valid reasons for the existence Goldman Sachs "Muppets" running joke. ***"O, what a precious comfort 'tis, to have so many, like brothers, commanding one another's fortunes!"*** *(Timon of Athens)* If everyone is doing something, it must be right. When all the players are interconnected and there is a perception of collective purpose then people feel even more comfortable. What really matters is alignment of interests, without this, the result can be ruinous. ***"'Tis time to fear when tyrants seem to kiss."*** *(Pericles, Prince of Tyre)* When the powerful seem to be giving something to the commoners, it is time to be fearful. Insiders don't sell at bottoms; IPOs, debt issuance and M&A activity all peak at market tops to allow the rich and powerful to exchange their paper wealth for cash from the masses who long to buy what they wish they would have bought and what is popular in the media. ***"Bad is the world, and all will come to naught when such ill-dealing must be seen in thought."*** *(Richard III)* Conflicts of interest lead to bad decisions, and bad policy and self-interest is a very difficult adversary. John Kenneth Galbraith lamented that "the Bezzle" (corporate stealing) has always existed and it ebbs and flows over time. The conflicts and malfeasance start small (for fear of being caught) and as more and more get away with it, the bezzle grows until it reaches a point where society reacts, either through regulation or legislation, and the bezzle shrinks away for a time until the cycle restarts. ***"Ill deeds are doubled with an evil word."*** *(The Comedy of Errors)* It is one thing to do something wrong, but another thing altogether (doubly bad) when there is mal-intent involved. ***"The miserable have no other medicine but only hope."*** *(Measure for Measure)* Hope is not an investment strategy, but when investors find themselves in a losing position, many turn to that exact emotion. A related issue is that when people don't have a lot (they are miserable in circumstance), they will listen to (and follow) those that promise hope. We see this play out in myriad investment schemes that are perpetrated against the masses to try and rob them of what little savings they have. Always remember that that long lost relative in Nigeria really doesn't have a million dollars to park in your account if you will just give him your account number.

Shakespeare on Appearances

"So many the outward shows be least themselves, the world is still deceived with ornament." *(The Merchant of Venice)* It is easy to be deceived by the trappings of wealth and success (particularly in a world where media is so focused on these trappings), but many that appear to be successful are not what they seem. Don't take things at face value and always dig a little beneath the surface to make sure what you are seeing is real and durable. ***"Who makes the fairest show means the most deceit."*** *(Pericles, Prince of Tyre)* A common theme in Shakespeare's work is people who appear to be the fairest are actually the least fair. In investing, if something looks too good to be true, it is. ***"False face must hide what the false heart doth know."*** *(Macbeth)* Those with ill intent are expert at wearing masks and appearing to be what they are not. Remember that desperate people will do desperate things. This is particularly a problem when GAAP accounting rules allow such broad interpretation of what face you can present to the world irrespective of how false that face may be relative to reality. ***"And some that smile have in their hearts, I fear, millions of mischiefs."*** *(Julius Caesar)* Shakespeare loved the imagery of the smiling assassin who understands that in order to get close enough to do you harm (no sniper rifles in the 1500s) you can't be growling and scary on approach. ***"The prince of darkness is a gentleman!"*** *(King Lear)* Beware the person bearing only glad tidings, even the worst people may appear gentlemanly, but have ulterior motives, so you must always consider the source and the incentives. ***"The devil can cite Scripture for his purpose. An evil soul producing holy witness is like a villain with a smiling cheek, a goodly apple rotten at the heart. O, what a goodly outside falsehood hath!"*** *(The Merchant of Venice)* The best promoters can cite sound, purposeful reasons for whatever they propose and will even resort to calling on scripture to legitimize their proposal if it suits their audience. One of the most dangerous things in life (and investing) is someone with ill intent who puts on a smiling face to convince you to buy something. From the stereotypical used car salesman to the bucket shop stock peddler to the silver tongued corporate CEO, the better they look and sound, the more guarded you should be before parting with your hard earned cash. ***"The fiend gives the more friendly counsel."*** *(The Merchant of Venice)* Your friend will tell you the truth, which can sometimes seem downright unfriendly. The fiend will always tell you what you want to hear, which will always seem most friendly. Beware the consistently friendly counsel. English Bishop Dr. John Bridges said (not from the Bible, as many think) in 1587 that, "a fool and his money are soon parted," and only a fool would believe that all news is good news. A great example of the importance of this quote relates to sell side analysts whose job it is to tell you good news about companies so you will buy what they have to sell (this explains the predominance of Buy versus Sell recommendations they publish). A perhaps even more fiendish view would be that analysts create recommendations that are the opposite of the prop desk of the firm so that they have a source of supply/demand for what the firm is trying to buy/sell (but I am sure that never happens).

Shakespeare on Trust

"Hell is empty and all the devils are here." *(The Tempest)* There are (unfortunately) lots of bad actors in the investment business and investors have to constantly be on guard against those that would like to separate them from their wealth. ***"But 'tis strange. And oftentimes, to win us to our harm, the instruments of darkness tell us truths, win us with honest trifles, to betray's in deepest consequence."*** *(Macbeth)* The bad actors will tell us partial truths to lead us to the dark side (our destruction). They earn our trust by telling us truth about inconsequential things then betray us when it will inflict maximum damage. Some might say that is how prop desks used to operate where the research side says one thing and the prop desk takes the other side of the trade with house money. ***"O time most accurst! 'Mongst all foes that a friend should be the worst!"*** *(Two Gentlemen of Verona)* It is bad enough when things go wrong, but it is worse when someone you think was your friend (let's use a research analyst in this case) actually turns out to be conflicted (agency problem) and quickly turns into a foe. Investing is hard enough to begin with, but it becomes really challenging when the experts you turn to as resources actually have ulterior motives (like selling investment banking deals) and don't actually give you the whole story. ***"For trust not him that hath once broken faith"*** *(Henry VI, part 3)* Trust and confidence are the most important elements in relationships, particularly in investing. While the standard of a single breach of faith may seem a bit steep, there is a reason for the wisdom of the saying "fool me once, shame on you, fool me twice, shame on me." I have often said that you can apply this wisdom to other areas as a means for deciding whether to work with someone (or allocate capital to them) in that if someone cheats at golf, they will cheat you, if they cheat on their taxes, they will cheat you and if they play fast and loose with the numbers in accounting, they will cheat you.

"The tempter or the tempted, who sins most?" *(Measure for Measure)* An age old question is who commits the bigger sin, the one who makes big promises or the one who accepts the promise at face value and never challenges the details, but rather simply goes along with the temptation? ***"Foolery, sir, does walk about the orb like the sun; it shines everywhere."*** *(Twelfth Night)* Unfortunately, there will always be another Madoff, Enron or Sino Forest, but it doesn't mean you should stay out of the sun all the time. If you are headed to the beach, you put on sunscreen to protect yourself, if you are headed into the investment universe, you do your diligence, diversify appropriately and hedge when necessary.

Shakespeare on Incentives

"Having nothing, nothing can he lose" *(Henry VI, part 3).* Like a dog backed into a corner, be particularly wary of those who have nothing to lose. Essentially this problem comes down to a misalignment of interests, made worse by basic survival instincts. Take the example of a CEO who has seen their stock price fall to the point where he is no longer eligible for any bonuses or incentives, how motivated are they to swing for the fences and take ill-advised risks because if they don't work, they don't lose any more, but it they work, they can recapture those incentives. The problem is that these types of moves are seemingly always asymmetric and the losses to shareholders on the downside always exceeds the benefits to them during the upside. ***"Presume not that I am the thing I was. For God doth know, so shall the world perceive, that I have turn'd away my former self. So will I those that kept me company."*** *(Henry IV, part 2)* Time keeps moving on and things change and what was attractive at a low valuation (or high growth) is less attractive over time as capitalism leads to higher valuation (or lower growth). Being disciplined in investing to continually rotate capital away from what has recently been successful toward things that have become cheap is the surest path to long-term wealth creation. A note of extra caution is necessary here when thinking about how the wisdom of this passage applies to the U.S. equity market today. We have made our own bed by cheering on the financial engineering of leveraging balance sheets and buying back stock to boost EPS and now we must lie in it. When companies issue debt to buy back stock with the aim of pumping up management compensation they hollow out the company. Bad things happen and those that keep company with these hollow shells and they will be turn'd away from their former wealth. ***"No, no, I am but shadow of myself. You are deceived, my substance is not here."*** *(Henry VI, part 1)* Shareholder Value Maximization (SVM) was supposed to be (as the name implies) a program to increase the value of companies that inure to the shareholders. Unfortunately, that is not the way things played out and this quote perfectly describes what has become of our once mighty S&P 500 constituents (clearly this does not apply to all companies, just the overleveraged ones). Companies have been hollowed out by excessive borrowing to buy back shares in an effort to juice EPS and reward management through stock options. The deception is real, these companies are precisely a shadow of their former selves and the rampant M&A and LBO activity has stripped the substance away and left hollow shells (selling at record high prices, but who's counting). ***"Nature teaches beasts to know their friends."*** *(Coriolanus)* The law of the jungle applies to investing in one particular way; know your friends and your enemies. Always focus on agency problems and try to keep your portfolio invested in things where there is alignment of interests. Investing experience teaches us where our edge is, some are great traders, some are great fundamental analysts, some have a value bias and some are more prone to favor growth. When an animal interacts with other beasts in jungle, they learn if he is friend or foe and when we interact with beasts in the investment jungle, we learn the same. ***"Why, as men do a-land; the great ones eat up the little ones: I can compare our rich misers to nothing so fitly as to a whale; a' plays and tumbles, driving the poor fry before him, and at last devours them all at a mouthful."*** *(Pericles, Prince of Tyre)* The rich get richer and they have a significant advantage in the game. Always be very wary of people trying to sell you something. I used to say that I would always invest alongside Richard Rainwater (RIP), but would never buy anything from him because if he was selling, the price was too high (he was just that good as an investor).

Shakespeare on the Central Banks

"You speak an infinite deal of nothing." *(The Merchant of Venice)* In Texas they might say "All hat, no cattle;" others might say, "All bark, no bite." Both basically mean a whole lot of words, not much substance. Super Mario Draghi is the most extreme offender of late with his long, elegant speeches and his constant promises to, "do whatever it takes," while actually doing hardly anything at all (although he finally did get QE going in the EU, albeit a QE-lite version). ***"I wish my horse had the speed of your tongue."*** *(Much Ado About Nothing)* Those who talk fast and loose are likely hiding their true intent. The more the global Central Banks jawbone about how they have everything under control, the more we should worry. ***"Action is eloquence."*** *(Coriolanus)* Talk is cheap, action matters. Saying "Whatever it takes" is vastly different from doing whatever it takes and no matter how eloquent the speech, actions speak louder than words. ***"And 'tis a kind of good deed to say well and yet words are no deeds."*** *(Henry VIII)* Talk is insufficient, even if jawboning can make markets go up, ultimately action is required to add value. ***"Confusion now hath made his masterpiece."*** *(Macbeth)* When you can't dazzle them with facts, baffle them with bull-stuff. Obfuscation and confusion make people more dependent on the powerful. We might say that the Central Banks have created a global investment environment at present that is truly a masterpiece of confusion. ***"Thou sodden-witted lord! Thou hast no more brain than I have in mine elbows."*** *(Troilus and Cressida)* The most powerful people are not necessarily the smartest or most insightful. Positions of power do not endow the inhabitant with great wisdom. In fact, oftentimes the average person has far more intelligence and definitely more common sense than the Lords and Ladies. ***"Can one desire too much of a good thing?"*** *(As You Like It)* Unquestioned faith in anything is misplaced and too much of anything is a bad idea. Things taken to excess cause problems (no matter how well intentioned) and it appears that we find ourselves here today in the investment markets with our unquestioning faith in Central Bankers and QE. Someone I follow on Twitter said something very wise, "I remember a time in investing when I didn't know the names of the heads of the Central Banks. I wish to go back to that time." ***"Dispute not with her: she is lunatic."*** *(Richard III)* It is possible that this phrase is being taken out of context, but it applies so well to QEeen Janet today that I will take the poetic license. Never argue with a crazy person because they will drag you down to their level and beat you with experience. The problem is that if she awakens from her *Midsummer Night's Dream* and realizes the error of her QE ways, she would indeed make all the doves cry.

Shakespeare on QE

"What's in a name? That which we call a rose by any other name would smell as sweet." *(Romeo and Juliet)* It is pretty straightforward to understand the point here, that the name of something is less important than the actual object. In fact, if we think about language, there are many words across different languages for the same thing, but the underlying thing is the same. Something that has never made sense to me is how debt has been romanticized over the past few decades and we now refer to debt in many different ways, some of which even have somehow taken on positive connotations. In the old days, if you had a lot of debt, you went to Debtors' Prison. Today if you have a big Line of Credit (LOC), you are a big man/woman/company. Fixed Income Index Funds and ETFs weight the underlying holdings by the outstanding debt of a country/company as if it is somehow a good thing to have more debt (is it lost on them that higher debt levels indicate higher default risk?). Central Banks provide "Stimulus" or "Quantitative Easing" and it is romanticized to be some kind of panacea for low economic growth (despite direct evidence to the contrary) when it is simply more debt. In the end, debt is debt, no matter what name you call it (and it doesn't smell sweet or look pretty) and it must eventually be repaid. ***"My bounty is as boundless as the sea, my love as deep; the more I give to thee, the more I have, for both are infinite."*** *(Romeo and Juliet)* While this is a beautiful sentiment around the ideal of love, that there can be a boundless, replenishing reservoir with infinite reserves, the construct doesn't actually transfer over to capital markets, despite the best efforts of global Central Bankers to prove the contrary. If creating wealth was as easy as printing money then why wouldn't every Central Bank simply print as much as possible and everyone could be rich? Since 2009 we have seen the grand experiment with Quantitative Easing (QE) unfold and watched Ben, Mario, Haruhiko and Janet do their best Juliet impersonation to prove who has the bigger heart. While there has been an intermission in the QE balcony scene, there are those (ourselves included) that believe we are in for #QEInfinity. ***"Now, master doctor, have you brought those drugs?"*** *(Cymbeline)* Once someone becomes addicted, they must continue to take the drug or they will crash. We might argue that is how Central Banks (and investors who believe in CB omnipotence) feel today. ***"Unnatural deeds do breed unnatural troubles."*** *(Macbeth)* Extraordinary measures lead to extraordinary outcomes and, unfortunately, those are not always good things. The very essence of Quantitative Easing is unnatural and methinks it doth breed unnatural troubles in our future. ***"These violent delights have violent ends."*** *(Romeo and Juliet)* As massive liquidity was injected into the global capital markets following the Global Financial Crisis there were very sharp rallies in global equity and fixed income markets. The delights of the QE-fed financial asset reflation have been violent indeed and the investor frenzy to find places to put capital to work at returns above the Zero Interest Rate Policies of global Central Banks has pushed valuations to extremes. The problem with extreme valuations that arise quickly is the violent ending, and as the old saying goes, the bigger they are, the harder they fall. ***"He lends out money gratis and brings down the rate of usance here with us in Venice."*** *(The Merchant of Venice)* It is a very simple identity function, when the cost of capital goes to zero, the return on capital goes to zero. Capitalism works and ultimately water finds its own level, meaning excess capital and debt will eventually destroy prosperity. What the global Central Banks have done is centuries old, it didn't work in Venice and it won't work in D.C., Tokyo or Brussels either.

Shakespeare on Consequences

"What's done cannot be undone." *(Macbeth)* You can't take back bad decisions and you have to live with the consequences. You can, however, try to mitigate the damage once the bad decision has been made and you see the outcome on the horizon. ***"'Tis hatched and shall be so."*** *(Taming of the Shrew)* Once you rub the lamp, you can't put the genie back in the bottle. You have to take your wishes and complete the transaction. The same construct applies to investing; once you commit capital (long or short) you have to endure the consequences (good or bad) until you complete the transaction on the other side (sell or cover). Taking it up a notch, once a grand plan is unleashed, it must play out and it often moves beyond the control of those who hatched the plan in the first place. QE is an example, the global Central Banks let the money supply genie out of the bottle and there is no going back now. What we have to hope now is that the hatchling looks more like a baby alligator (dangerous but manageable) than a T-Rex (dangerous and unmanageable). ***"I have almost forgotten the taste of fears: The time has been, my senses would have cool'd to hear a night-shriek; and my fell of hair would at a dismal treatise rouse and stir as life were in't: I have supt full with horrors; Direness, familiar to my slaughterous thoughts, cannot once start me."*** *(Macbeth)* The more you engage in something, the more comfortable you become with it, particularly if there are no bad consequences immediately. When you lose all fear, bad things happen. For example, if we don't take care of ourselves (eat right and exercise) bad things will happen, but most people don't take good care of themselves because the downside is not immediate. Why does hardly anyone ever run out of gas? Even though none of us have an extra 10 minutes to do anything, let alone stop at the gas station, we always find a way, because the consequences are immediate and dire. ***"Pleasure will be paid one time or another."*** *(Twelfth Night)* When we indulge in something pleasurable, a good meal, a theatre performance or the like, we pay for the experience. Sometimes, particularly when we overindulge, there is additional compensation extracted at a later time as well. Whether overeating, over imbibing, becoming over-indebted, moving prices toward overvaluation, or becoming too dependent on Central Bank largesse, there will come a day when you must pay, even if you bought it all on credit. ***"Alas, poor country, almost afraid to know itself! It cannot be called our mother, but our grave."*** *(Macbeth)* Civilizations have a long history of pushing themselves past the brink of order, into chaos and ultimately demise. The unfortunate truth is that all empires end (Ottoman, British, Roman) and the current empire just so happens to be the United States. ***"The commonwealth is sick of their own choice. Their over-greedy love has surfeited. An habitation giddy and unsure hath he that buildeth on the vulgar heart."*** *(Henry IV, part 2)* Countries around the world chose their path (commodity focused, investment focused, consumer focused) and the wealthy developed world has chosen a path of comfort financed by debt. We know the last act of this play, the largesse will eventually lead to a period of retrenchment, a sickness of their own making, similar to over indulging at a party and having to deal with the hangover the next day. Anything taken to excess is vulgar, greed is one of seven deadly sins and (as Prince reminds us in 1999) all parties must end. ***"The sins of the father are to be laid upon the children."*** *(The Merchant of Venice)* The definition of entitlement is a promise we make to ourselves that we ask our kids to pay for; in a word, genius. It is simple to make promises that you don't have to actually pay for, but the debt burden that these promises place on developed markets economies is extreme and can be seen in declining GDP growth rates and the need to resort to extreme measures of monetary policy to try and stimulate growth. ***"He that dies pays all debts."*** *(The Tempest)* Death is indeed one way to get out of debt, not entirely preferable, particularly when thinking about entire countries.

Shakespeare on Popularity

"Until I know this sure uncertainty, I'll entertain the offered fallacy." *(The Comedy of Errors)* Sometimes everything that is happening is so incomprehensible (the result of error and illusion) that one may decide to simply accept the benefits while they exist and postpone worries about paying the piper in the future. The current excess liquidity fueled bubbles in places like government and corporate debt, commercial real estate and certain equity markets (like the U.S.) have arisen from this cavalier attitude as the creation of debt (at all levels, household, corporate and government) has reached such incomprehensible levels that many investors have simply decided to go along for the ride. ***"Idol of idiot-worshippers!"*** *(Troilus and Cressida)* Do not assume greatness because of popularity. Just because everyone is enamored of someone (or something, like an asset class or investment strategy) doesn't mean it is good or will make strong returns. In fact, there is usually an inverse relationship between popularity and future returns. ***"Beauty is bought by judgement of the eye."*** *(Love's Labour's Lost)* Beauty, clearly, is in the eye of the beholder, and what one person sees as beautiful, another may see as ordinary. There truly is no accounting for taste. Perhaps the best examples today are the outrageous prices being paid for works of art. While some clearly see these pieces as beautiful (worthy of multiple millions), many (including the writer) just don't see it. Investing is a parallel pursuit. Different investors have varying risk appetites and preferences when it comes to how they determine value and invest. The subtle difference, however, is that a work of art is merely a tangible asset that generates no cash flow so the value is determined solely by what some greater fool will pay. Securities (claims on the cash flows of a business) are quite different. There is a fundamental value, and when stocks become a beauty contest (as we contend they are today), there will be more losers than winners. ***"I assure thee: setting the attractions of my good parts aside I have no other charms."*** *(The Merry Wives of Windsor)* Unfortunately, with many things in life, things are not always as they appear and oftentimes there is not much beneath the enticing exterior. Investing requires a shrewd eye, and you need to be extra careful when assessing opportunities that look particularly attractive in one aspect. A frightening example of this surface level attraction might be found in the non-traded REITs that were peddled by salespeople working for huge commissions (6%+) while they reeled in clients with the bait of huge current yields (8%+). The problem arose when there were no real estate assets available at that yield, so they just distributed capital. What is truly jarring about this example is that accounting rules (preserved by huge lobbying dollars) allowed the firms to show clients par (no discount for commissions and capital distributions). Clean capital statements hid the deceit, and hoodwinked investors didn't discover they had eloped with the wrong suitors until they were far out of the woods (and it was impossible to recover losses).

Shakespeare on Overconfidence

"Lord, what fools these mortals be!" *(A Midsummer Night's Dream)* My investment take on Puck's famous quip is that when making investment decisions, humans are extraordinarily good at buying what they wish they would have bought and selling what they are about to need. Einstein said, "Insanity is doing the same thing over and over expecting different results." Perhaps this is further proof that the mischievous fairy's words to King Oberon were accurate. ***"The fool doth think he is wise, but the wise man knows himself to be a fool."*** *(As You Like It)* Knowing that we don't know is a precious commodity and such mindfulness allows us to make good decisions. More importantly, that lack of ownership of the idea allows us to be skeptical of every decision and vigilant in monitoring new information that would make us change our mind. The fool is convinced they are right and will often (as one of my favorite managers, Tom Marsico, used to say) "hit the wall with no skid marks." ***"Nothing that is so, is so."*** *(Twelfth Night)* When you are absolutely sure of something (can be anything, but utilizing investing as a convenient example), you are probably wrong. Mark Twain so eloquently said, "It ain't what you don't know that gets you into trouble, it is what you know for sure that just ain't so." One of the most important skills in investing is cynicism, the ability to question beliefs, constantly search for non-confirming information to test your investment thesis, and protect your portfolio from being blindsided. Things are not always as they appear, and we always need to look beneath the surface. ***"For man is a giddy thing, and this is my conclusion."*** *(Much Ado About Nothing)* Humans are inherently optimistic. They want to believe that the good times can last forever. The spoiler is, of course, that they don't (they cannot because the good times sow the seeds for the eventual decline). Optimism is a good thing as it allows us to move forward each day despite the myriad things that could hold us back. I often talk about the unbridled optimism of the first cave man that thought he could kill a mastodon with a spear. Unfortunately, he didn't come back, but after a few dozen others disappeared, someone realized the vulnerable spot on the mastodon. Suddenly there was steak for everyone. Giddy, on the other hand, is a state we should all endeavor to avoid as it implies loss of reason and overly optimistic expectations. ***"Tell me where is fancy bred, or in the heart, or in the head?"*** *(The Merchant of Venice)* All relationships begin logically enough, with attraction to an ideal and a plan on how to navigate the relationship. However, as things mature, there is a shift from being governed by the head toward being governed by the heart, and the relationship turns to fancy, a loss of reason. When we lose reason, we are prone to actions of excess, where the margin of safety is lower. Take the example of buying a stock and setting a sell price target, a reasonable process. The stock zooms past your price target (Sell! Sell! Sell!). Nothing has changed fundamentally with the company other than other investors have taken a fancy to the stock but you decide to set a new (higher) target governed by emotion. You can guess the end of this story. Though more in line with *Hamlet* than the drama from which this particular quotation is drawn, between the poisoned cup and sword there are few survivors.

Shakespeare on Delusion

"The breaking of so great a thing should make a greater crack: the round world should have shook lions into civil streets, and citizens to their dens." *(Antony and Cleopatra)* In the play, the death of a King (or for our purposes the breaking of a trust) should have elicited a stronger response. Alas, investors like to make returns, and will often look the other way as long as their portfolios are rising. ***"What our contempt often hurls from us, we wish it our again; the present pleasure, by revolution lowering, does become the opposite of itself."*** *(Antony and Cleopatra)* We always want what we can't have. Once something is gone (even if gone because we rejected it) it becomes what we desire. Relatedly, what's enjoyable today fades as time rolls on. ***"How bitter a thing it is to look into happiness through another man's eyes!"*** *(As You Like It)* Fear of Missing Out (FOMO) is a powerful emotion and there is nothing more dangerous to reason than to watch your neighbor get rich. When you see others get rich (particularly when you perceive them to be less talented than you) you will start making bad investment decisions in an attempt to chase after someone else's riches instead of focusing on the provided investment opportunities. Some great advice to follow here is to never compare your chapter one with someone else's chapter twenty. ***"Men in rage strike those that wish them best."*** *(Othello)* What should really enrage investors is permanent loss of capital during debt deleveragings or the destruction of wealth by the silent thief of inflation, but the reactions to these events pale in comparison to the rage incited by missing out on a quick jump in the equity markets. I could probably pen an entire letter (maybe someday) on the psychological underpinnings of behavioral finance and investor reactions to market events, but here I am simply making the point that FOMO triggers an extremely powerful emotional response in equity investors. The problem is that investors' panic at the bottom of the cycle (when they should be buying), and sell their equity investments, replacing this exposure with hedge funds (because they performed so well during the drawdown). As equity markets recover, the long-only strategies outperform the hedge funds, and the rage begins to grow. The longer the move up (like 1995 to 2000 or 2009 to 2015), the greater the rage, and in a final crescendo investors begin to lash out at the hedge fund industry. Some even make public announcements that they are redeeming from the industry (they always fail to mention the part about buying after the last market drop…). Investors can't hear the warnings at the top because the hedged strategies have underperformed and the rage clouds their judgment. Hedge Funds work when they protect against losses in the downturns and keep the power of compounding working for investors. The key advantage of Hedge Funds is their investment model, and it would be wise for investors to resist the urge to sell what they are about to need today. ***"Good my lord, be cured of this diseased opinion, and betimes. For 'tis most dangerous."*** *(Winter's Tale)* Shakespeare is referring to jealousy (again, we can think FOMO) and how dangerous that emotion can be. We can also apply the wisdom to giving up on a bad idea when the weight of the evidence shows the opposite, like QE promoting GDP growth (which in fact reduces monetary velocity) or the attractiveness U.S. equities when valuations are near multi-decade extremes.

Shakespeare on Honesty

"Who, I? Alas, it is my vice, my fault: Whiles others fish with craft for great opinion, I with great truth catch mere simplicity; Whilst some with cunning gild their copper crowns, with truth and plainness I do wear mine bare. Fear not my truth: the moral of my wit is 'plain and true;' there's all the reach of it." *(Troilus and Cressida)* Often, people in powerful positions will tell you what you want to hear so long as it continues to gild their crown (read, keep them in power, or keep you paying them for advice). The truth is so rarely spoken because it has the peculiar effect of unpopularity. Alas, the power of the truth is that the more people rail against what you have to say, the more likely it is that your unpopular view proves right. My favorite example of this phenomenon was in late 1999 when I told our Board at UNC that Jeremy Grantham (CIO of GMO) was very worried about equity valuations (he thought the S&P 500 would have a negative return for the next decade, p.s. it actually did) and my chairman said, "Mark, you are no longer allowed to use the letters G, M or O in a sentence ever again… " He was convinced that Jeremy's protestations about silly valuation levels were unfounded. While Jeremy had indeed been early, he was right, and those that chose not to follow his counsel ended up with rather tragic returns (I didn't give up on the alarm sounding. When the party ended in 2000, we had replaced exposure to equities with hedge funds, and were able to stay flat while the S&P 500 lost (40%) over the next three years). ***"All that follow their noses are led by their eyes but blind men; and there's not a nose among twenty but can smell him that's stinking."*** *(King Lear)* Don't believe everything you see. Sometimes it takes someone without a particular skill/sense to see the reality that everyone else is blind to. When everyone is simply following the King (or other authority figure) then there is not a lot of thinking going on. If no one is willing to speak up that something stinks then the rot will fester for longer and can become truly problematic. ***"What a fool honesty is!"*** *(Winter's Tale)* The investment business is built on good news, more buy recommendations rather than sell recommendations, bull markets stories rather than bear market stories. Speaking honestly about valuation and risk can be very costly to reputation and business (GMO lost half their business in 2000 when everyone was convinced they were wrong about equity valuation. However, their AUM has increased ten times since so they are OK). ***"I am not bound to please thee with my answers."*** *(The Merchant of Venice)* Today we live in a Participation Trophy world where everyone is a winner (there are no sell recommendations only holds). There is only supposed to be universal positive feedback (for fear of hurting someone's self-esteem), but in the Shakespearean world Shylock states the truth (and he doesn't care if you like it). Sometimes the truth is painful but critical to hear so as to avoid continuing to do something that might be harmful. In investing it is critical not to always seek the comfort of those that agree with you, or tell you what you want to hear. One must seek out their own Shylock who will give it to you straight. ***"O, while you live, tell truth, and shame the Devil!"*** *(Henry IV)* Truth is an absolute defense, even when offered against those that sound more attractive and impressive. It is hard to speak up against the powerful, the entrenched, and the consensus because it will feel very uncomfortable and no one will want to hear what you have to say. If you have done the work, speak your truth anyway. ***"Let it be virtuous to be obstinate."*** *(Coriolanus)* Don't be afraid to stand your ground when you have done the work; have courage in your convictions. In this context, to be obstinate implies that you are going against the authority, but we know that having variant perceptions is how we experience the virtue of making the big money. ***"No legacy is so rich as honesty.*** *(All's Well That Ends Well)* In law, truth is an absolute defense. Truth wins over all the legalese and negotiation. It follows then that honesty in all relations, despite difficulty, will leave the richest legacy in the long run (though it may cause the sacrifice of short-term "friends").

Shakespeare on Character

"He is as full of valor as of kindness. Princely in both." *(Henry V)* Though to be a prince does not promise survival, princely genius, shown either in the valor of an age old drama or a pop song, is to be admired. Fulfillment comes easier from courage and kindness in both investing and life. ***"Modest doubt is call'd the beacon of the wise."*** *(Troilus and Cressida)* From the ancient masters we have read that the most wise know that they do not (and cannot) actually know anything, so they always have a healthy level of doubt. Shakespeare reminds us of the power of humility and skepticism, and we reiterate that becoming a great investor is impossible without these character traits. ***"I dare do all that may become a man; who dares do more, is none."*** *(Macbeth)* There are limits to what you should do in life and investing is no different; always stay on the bright side of the line. ***"Love all, trust a few, do wrong to none. Be able for thine enemy rather in power than use and keep thy friend under thy own life's key. Be check'd for silence, but never tax'd for speech."*** *(All's Well That Ends Well)* Do the right thing and be loyal to your friends. Be able and ready to show power, but avoid using power unless you really have to. In essence, train so you don't have to fight (wisdom from the Karate Kid). Don't speak rashly, but don't be at a loss for words when it is necessary to speak. Don't be a Chicken Little (running about with threats of disaster), but don't hesitate to speak up forcefully when you really think the sky is falling. ***"Have more than thou showest, speak less than thou knowest, lend less than thou owest, ride more than thou goest, learn more than thou trowest, set less than thou throwest."*** *(King Lear)* Success in life and investing can be achieved following this simple wisdom. Be humble in temperament and reserved in action so that you have assets ready to deploy when things get interesting. ***"How far that little candle throws his beams! So shines a good deed in a weary world."*** *(The Merchant of Venice)* Little things mean a lot, and they mean even more when things are difficult. In this example, a small beam of light can make a huge difference in true darkness, whereas it might hardly be noticed at dusk. Doing the right things right is increasingly important in the weary investment world we find ourselves in today, where the grand experiment of QE may be losing some of its luster and investors grow weary waiting for the resumption of growth.

Shakespeare on Greatness

"Men at some time are masters of their fates. The fault, dear Brutus, is not in our stars, but in ourselves, that we are underlings." *(Julius Caesar)* No one can make you successful more than yourself, but in order to be successful, you must seize your fate. You make your own future by making decisions and acting, but the challenge lies in overcoming the human frailties of fear and lack of confidence. In investing, there will always be myriad reasons not to do something, not to invest, not to take risk. The human condition is quite comfortable with the inaction, in staying in the comfort zone. Great investors operate by the mantra of #LiveOutsideYourComfortZone, and are not content as underlings; rather, they aspire to greatness and are not afraid to be masters of their own fate. ***"Be not afraid of greatness: Some are born great, some achieve greatness, and some have greatness thrust upon them."*** *(Twelfth Night)* The job of investors is to identify opportunities and capitalize on them. Malvolio reminds us how important it is not be afraid of winning. Furthermore, is not the goal of investing to multiply wealth? When studying investment behavior, legendary investor Peter Lynch noticed that most people "pulled their flowers and watered their weeds," which assures poor performance. He would tell you to do the opposite "let your flowers grow and pull your weeds." Paul Tudor Jones was famous for saying, "Losers average losers," and Julian Robertson had an uncanny knack for "doubling up" (We have created a hashtag for this, #WinnersPressWinners) ***"Be great in act, as you have been in thought."*** *(King John)* One of the things I talk about a lot is what gives investors an #Edge. Among many other important attributes, action truly equals edge. If you don't act, you can't win. One of the great challenges in life and investing is that we all make plans and spend a great deal of time thinking about things we should do, but oftentimes we don't get around to doing them or do them in a half-hearted way. Make sure your actions speak louder than your words. ***"Keep time! How sour sweet music is when time is broke and no proportion kept! So is it in the music of men's lives. I wasted time and now doth time waste me."*** *(Richard II)* In life, and in investing, missed opportunities are extremely costly because you can't get time back. The remedy is to keep time, to stay in the moment and seize opportunities as they come along. ***"Come what come may, time and the hour runs through the roughest day."*** *(Macbeth)* No matter how bad things get, this too shall pass and time heals all wounds. The best opportunities come when things look darkest and no one wants to deploy capital to that particular situation. ***"Who can be wise, amazed, temp'rate, and furious, loyal and neutral, in a moment? No man."*** *(Macbeth)* If you can keep your head about you while everyone else is losing theirs, you can be a very successful investor. This is harder than it sounds, but very profitable. ***"Well, every one can master a grief but he that has it."*** *(Much Ado About Nothing)* Always remember that it is very easy to say what to do to recover from misfortune, or to solve a problem, when you are not mired in it. It is extremely difficult, however, to think clearly when you are amidst a challenging situation with chaos all around you and the pressure is on. ***"All's well that ends well."*** *(All's Well That Ends Well)* There will be uncertainty in life and trouble along the journey but a good outcome is a good ending. Like golf, the score is a number, not a picture; par is par even if an errant second shot into bunker and a sandy putt allow it to be so. As the old saying goes, "They don't ask you how. They just ask you how many." Investing is the not all that different. The end result, an increase in wealth over time, is what truly matters, and if there happen to be some ugly investments along the way, that is to be expected.

Shakespeare on Gratitude.

"All the world's a stage, and all the men and women merely players. They have their exits and their entrances and one man in his time plays many parts." *(As You Like It)* We are all just participants in the markets, and we will make many entrances and exits and over a lifetime of investing. Over the course of an investing career, we will play many parts. Sometimes we will lose because we won't always see the ball clearly; sometimes we will win because we have done good work. Other times we will have periods of good fortune (luck). Two thoughts on luck apply here. Thomas Jefferson said, "I am a great believer in luck, and I find the harder I work, the more I have of it." One of my good friends at UNC (who was a great college QB) was fond of the saying "Luck is where preparation meets opportunity." ***"'Tis a lucky day, boy, and we'll do good deeds on it."*** *(Winter's Tale)* Luck plays an important role in investing, and recognizing that luck is fortuitous (not skill) is critical. When fortune favors us, we must make hay while the sun is shining. We are but stewards of our wealth, so recognizing our responsibility to do good deeds when we have the ability is important. ***"Striving to better, oft we mar what's well."*** *(King Lear)* The danger of always wanting more is that we may lose what we already have. Those that think that there is always something better in the bush are apt to lose what they already have in their hands. ***"Money is a good soldier, and will on."*** *(The Merry Wives of Windsor)* While the Apostle Paul may be right in telling Timothy that "the love of money may be the root of all evil," anything taken to excess is potentially dangerous. Thus, if the accumulation of money is not rooted in ethics and the morality of stewardship that is inherent to proper investment, than it may overwhelm our priorities, blind our perspective and lead to an idolatry of wealth (which in the Faith of both Paul and Timothy, is the substitution of a material expedient in the place of the First Commandment). Finance is not a pure industry. However, frauds and nefarious actors overshadow the opportunity for good work when capital is deployed in an intelligent and consistent manner. ***"All that glitters is not gold. Often have you heard that told many a man his life hath sold, but my outside to behold gilded tombs do worms enfold."*** *(The Merchant of Venice)* The imagery of this scene in having Morocco pull a scroll from the eye socket of a skull and read this passage is fantastic. In short, the shiny metal is not the only important thing and certainly not worth selling your soul because in the end even the wealthiest become food for worms. Wealth is not the most important thing in life, and while money can (and does) make things easier, the single-minded pursuit of money usually leads to ruin. Investing can indeed become an all-consuming passion, but there is a huge difference between doing something you love, embracing the thrill of the competition and being a slave to the almighty dollar. ***"Things won are done; joy's soul lies in the doing."*** *(Troilus and Cressida)* Achieving a winning outcome is great, but the true joy in life comes from the process and the living along the way. Building things brings great joy. In investing, we find that the process of identifying opportunities and bringing them to fruition is the real joy. (Don't get me wrong. We like to win and make money, but the passion for the business comes from the journey rather than each destination) ***"Heat not a furnace for your foe so hot that it do singe yourself."*** *(Henry VIII)* Don't hate those that disagree with you (or anyone, for that matter). This is particularly true in investing where you always need to invest without emotion, because if you don't, hate will cause you to lose perspective, make bad decisions and get burned.

Shakespeare on Caution

"What's past is prologue." *(The Tempest)* Past performance is not a guarantee of future results, but it can still be instructive. Recently, rapid price increases have been followed by falls and price declines have been followed by rises (on average, there are always singular exceptions). Winston Churchill said, "The farther back you can look, the farther forward you are likely to see," and that wisdom is particularly true in investing. The most recent return pattern is unlikely to be repeated (in fact, likely to be the opposite in the near term), but when looking back at history you can find times many decades ago where circumstances were very similar (like comparing the 1930s to the 2010s). ***"O teach me how I should forget to think"*** *(Romeo and Juliet)* Great investors are disciplined. Great investors follow a repeatable process with a consistent set of rules. Great investors are thoughtful and are diligent in their attention to valuations and rebalancing their portfolio, buying when things go on sale and selling when things are overpriced. Romeo laments that he cannot stop thinking about fair Juliet so Benvolio simply says, "Don't think about her," to which Romeo replies something along the lines of, "Yeah, right. Show me how." U.S. equity investors are currently in a Romeo-like state as they stare longingly at equities that tempt them every day while their inner Benvolio is telling them to look away. Great investors listen to Benvolio and forget about fair maidens (markets) when valuations reach the lofty balconies of forbidden households (as they have today). ***"There is a tide in the affairs of men which, taken at the flood, leads on to fortune; Omitted, all the voyage of their life is bound in shallows and in miseries. On such a full sea are we now afloat and we must take the current when it serves, or lose our ventures."*** *(Julius Caesar)* What Brutus is telling us is that there is a tidal cyclicality to our lives that presents us with opportunities and challenges. On rare occasions the tide rises to flood level extremes and a truly extraordinary opportunity comes along. If we choose not to act right then, our life is less rich. The same is true in investing, opportunities wax and wane like the tides following the moon. Riding along with the tide (the trend) is, contrary to popular opinion, very profitable strategy. Soros makes the point more firmly saying that it does not pay to be contrarian except at the inflection points. Brutus tells us that the time is right to attack for their advantage in troops will never be greater. There are definitive times to deploy capital, and there are times when retreat is more beneficial. One can make a reasoned case that the current global tides are offering us a ride to greater heights in emerging market equities and potentially a wash out in the U.S. equity markets. ***"Fortune brings in some boats that are not steered."*** *(Cymbeline)* Luck can happen even when not paying attention and actively managing a portfolio. Sometimes indexes will do well simply because the tide is rising, but those times are few and far between (and usually associated with Central Bank largesse). Over full market cycles it makes no sense to us that the optimal way to buy stocks is to buy more of them as they become more expensive, but that is precisely what Index Funds do and they guarantee that you will have the maximum exposure to the wrong asset as the wrong time (TMT in 2000, Financials in 2007, Energy 2015). ***"O, how this spring of love resembleth the uncertain glory of an April day, which now shows all the beauty of the sun, and by and by a cloud takes all away!"*** *(Two Gentlemen of Verona)* Quite simply, things always look best right before they are about to change. The math in investing works that way too as capitalism makes things mean-reverting and when something becomes too good (like margins, profits or stock prices) competitors come and take things back toward the average (usually below the average and the process begins in reverse). It is ironic that the quote uses April as the end of the glorious period before the clouds come, as we believe that *"Sell in May and Go Away"* will be great advice again this year for equity investors. ***"We have heard the chimes at midnight."*** *(Henry IV, part 2)* Contrary to popular belief in the investing business, they actually do ring the bell at the top. The problem is the revelers at the party are so drunk they can't hear the chimes. Like the title of this letter says, it is midnight. ***"All things are ready, if our mind be so."*** *(Henry V)* We will see things when our mind is ready. If we close our mind to new ideas and disconfirming information, we won't see new opportunities and threats to our existing investments. There are always great opportunities available if we are willing to let go of our old ideas and biases and allow the mind to perceive the new. ***"Time travels in diverse paces with diverse persons. I'll tell you who time ambles withal, who time trots withal, who time gallops withal, and who he stands still withal."*** *(As You Like It)* Over the course of your life there will be times to crawl, times to walk, times to run and times to stand still. In investing there are strategies for each time in the natural cycle. There are appropriate strategies when it is time to be cautious and conservative, time to be opportunistic, a time to be aggressive and go with the momentum, and a time to be completely defensive. When looking around the world at investment opportunities we can find places like commodities where it appears safe to start walking and places like the U.S. where it makes more sense to stand still (go to cash), or even back up a bit (be fully hedged). ***"It is far easier for me to teach twenty what were right to be done, than be one of the twenty to follow mine own teaching."*** *(As You Like It)* In life (and investing) saying what to do is easy, but doing what is right is hard. For example, it is easy to understand the best way to make money long-term, have a long time horizon, follow a value discipline, rebalance periodically, buy what is on sale, sell what is priced for perfection, take advantage of illiquidity premium, be greedy when others are fearful and fearful when others are greedy, simple. The hardest thing to do is actually follow your own advice. ***"Delays have dangerous ends."*** *(Henry VI, part 1)* Simply speaking, "he who hesitates is lost" or to restate for the investment world, "he who hesitates has loss." In investing one of the most important elements of success is to act and act quickly and decisively. Whether that action is to buy a new position, to add to an existing position, to sell an existing position or to short something that you believe will stumble in the future, you need to make a decision and move. Waiting for perfect information (you will never get it), the perfect investment environment (it will never occur) or the perfect time (you will always have too many distractions and priorities) is a fool's errand and the longer you wait, the more dire the consequences. T. Boone Pickens (the famous oilman and investor, who was also known as a quick trigger puller on terminations) said it best when asked about when he knows it is time to fire someone, *"The first time it enters my mind."* Missed opportunities on the buy side are merely reduced profits, but delays in selling can (and will) lead to dangerous ends (real losses).

Shakespeare on the Extremes

"True is it that we have seen better days." *(As You Like It)* Despite the best efforts of Governments (Fiscal stimulus) and Central Banks (Monetary stimulus) economic (and market) cycles continue unabated and as we stand today, we have indeed seen better times in the past for investors. Investing is about the future and you should always deploy capital in a counter cyclical manner to the prevailing condition of the economic environment. It makes logical sense that prices are lower (values are better) during hard times and price are higher (less good values) when times are good. ***"Fair is foul, and foul is fair."*** *(Macbeth)* There will be times when the world is upside down and notions of good and bad fail to apply properly like Q1 2016, Q1 2000 in the U.S. equity markets. ***"The world is grown so bad that wrens make pray where eagles dare not perch."*** *(Richard III)* Sometimes the world gets so turned upside down that the laws of nature fail to apply. In the investment world the same is true that at times things become so backwards that good companies go down and bad go up and it appears that the fundamental laws of capitalism and finance has been suspended. We witnessed such a period in Q1 of this year as the highest quality companies underperformed the worst companies and the best investment managers had truly terrible performance. That was the bad news, the good news is that King Solomon was right *"this too shall pass"* and the laws on nature/investing will revert back to normal. ***"Why, this is very midsummer madness."*** *(Twelfth Night)* At times, markets move toward madness. Charles Mackay described in his timeless investment classic *Extraordinary Popular Delusions and the Madness of Crowds* describes the phenomenon, saying, *"Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, and one by one."* If you can break away from the herd and are one of the early ones, it can be a very profitable position. ***"And worse I may be yet: the worst is not so long as we can say, "This is the worst.""*** *(King Lear)* If you can say, *"This is the worst,"* then things aren't done yet and are likely to get even worse. Like my high school wrestling coach used to say when someone would yell that they couldn't breathe when someone had then in a chokehold, "If you can talk, you can breathe." In battle (and investing) it is always the bullet you don't see that kills you so you must continually be vigilant in thinking "what can go wrong from here?" ***"For sorrow ends not, when it seemeth done."*** *(Richard II)* When things finally turn down they will go down go longer (and likely further) than you expect. Most people say they plan for the worst, but the problem is that they don't actually imagine the worst so they are unprepared when it unfolds. We see many examples in investing, but one that is highly relevant today.

Serial autocorrelation (once a trend starts it persists) in earnings occurs because CFOs are pretty good at playing the EPS game with the analysts. They under-promise and over-deliver and they are very adroit and massaging the numbers to keep the rise smooth and steady to attract the largest multiple from investors. The problem lies in when a company actually misses earnings, they tend to miss for multiple quarters in a row and the decline lasts longer and is deeper than anyone expected. The reason is that when the CFO finally runs out of accounting tricks, the profits cupboard is pretty bare and earnings drop for a while. With multiple quarters of falling EPS in the S&P 500 we see more sorrow ahead. ***"Something wicked this way comes."*** *(Macbeth)* This line is self-explanatory. The nice thing about investing is that things usually don't happen out of nowhere; rather, we are given plenty of signs and warning (e.g., there were lots of opportunities to exit Valeant between $260 and $26). Plenty of warning that is, so long as we are actually paying attention. "Surprises" always happen in the direction of the trend, that is companies in good trends tend to have positive surprises (FB always seems to crush earnings expectations) and companies in bad trends tend to have negative surprises (CS keeps finding new ways to destroy capital).

Shakespeare on the Endgame

"The game is up" *(Cymbeline)* Pretty simple really, that which cannot go on any longer, will stop. ***"In time the savage bull doth bear the yoke."*** *(Much Ado About Nothing)* Nothing lasts forever and time brings even the most powerful animal/trend to an end. Bull Markets, like bulls themselves, ultimately come to an end and the yoke of valuation can be put off for a while, but eventually all will succumb. ***"Well may I get aboard. [He sees a bear.] This is the chase. I am gone forever! [Exits pursued by a bear.]"*** *(Winter's Tale)* Amidst the 118,406 lines of Shakespeare's works, a dream of being pursued by a bear seems to apply quite nicely to the markets today. ***"Awake, dear heart, awake. Thou hast slept well. Awake."*** *(The Tempest)* It is time to wake up from our slumber and face reality, it has been a good ride, but now it is time to play defense and preserve capital. ***"There's small choice in rotten apples."*** *(Taming of the Shrew)* Shakespeare had a knack sometimes (ok, actually not very often as his writing is pretty dense) of saying things very simply, but with a little more flair than average conversation to keep things memorable. Rather than say there weren't many good options, the image of a bushel of rotting apples assaults more of the senses and hammers home the point of the message, that when a situation has become rotten, any choice is a bad one. This is the place we find ourselves in today in the equity markets, always lots of choices, but now the bushel is bad and while one bad apple still doesn't spoil the whole bunch (thank you Donnie Osmond), a bad bunch of apples does call for making the smart choice, none. ***"I would give all my fame for a pot of ale, and safety."*** *(Henry V)* Sometimes safety is the only thing you should be searching for (that and beer). We would argue that one of those times is upon us. ***"Let go thy hold when a great wheel runs down a hill, lest it break thy neck with following it."*** *(King Lear)* Once the trend actually changes, don't cling to the old notions, as it will break you, simply move out of the way. ***"A horse, a horse! My Kingdom for a horse."*** *(Richard III)* On the battlefield, the most common of items can become extremely valuable if they suddenly fall in quantity. In the investment market the same is true, liquidity only exists when you don't need it and in extreme situations (investment battles) the cost of liquidity (if you can get it at all) rises exponentially. ***"Better three hours too soon than a minute too late."*** *(The Merry Wives of Windsor)* When the stakes are high and downside is great, being early is definitely better than late. Not quite Shakespeare worthy, but it does rhyme. Mark Twain reminds us that *"history doesn't repeat, but it rhymes"* and we believe that some #2000.2.0 history is about to repeat and while we may have been a little early, that is OK. ***"But, soft! methinks I do digress too much,"*** *(Titus Andronicus)* (Please excuse me for making the point too many times.)

The Tragedy of Hamlet, Prince of Denmark

Like the Reduced Shakespeare Company, we think Hamlet deserves special billing (and its own section) and it fits perfectly with our Princely theme for the letter. Perhaps not all the wisdom from the other 36 plays, but a fairly good synopsis of the Bard's views on investing.

Hamlet delivers one of the most famous speeches in literary history which starts with ***"To be, or not to be: that is the question."*** Far too deep a subject to tackle here, Hamlet is contemplating whether to fight against what he considers an unbearable situation or end his life. Taking it down a few notches on the direness scale, investing is clearly not about life and death, but investing is important in the scheme of life as the assets being invested serve some purpose in funding the things that allow life to be lived (necessities), to be lived more fully (niceties) or to live on in perpetuity (endowment or foundation). How the beginning of the Danish Prince's epic soliloquy can be applied to portfolio management is pretty simple. As an asset owner, you should ask this question continually about the assets in your portfolio. Essentially the translation here is to Buy/Hold; or to Sell; that is the question. Continually reconsidering the role of each asset in the portfolio will force a discipline of rotating away from investments that have served their purpose and toward investments that are currently the most attractive. ***"Lord, we know what we are, but know not what we may be."*** The future is, by definition, unknowable. We know who we are today and we know what dreams and aspirations we have for tomorrow, but the path is uncertain and there are many alternate paths that may arise as we make decisions over time. We cannot know the outcome with certainty, but we can prepare ourselves to make a brighter future and influence our chances of success and with some good fortune, perhaps even achieve great things. Investing is the same, we know the facts as they currently exist and we have expectations for the future, but there will be many alternative scenarios that can play out and it is critical to have contingency plans for many different outcomes rather than trying to predict which outcome is likely. As Yogi Berra famously quipped, *"Making predictions is hard, especially about the future."*

One big challenge, however, is that ***"Our wills and fates do so contrary run."*** Just because you want/need to make 7% returns doesn't mean the market will give you those returns. In investing, the "fates" are the expected returns going forward and wanting and wishing intently won't change the outcome. Hope is not an investment strategy and no matter how hard you will it, what is baked in to the markets is what the returns will be over time. Bonds make a yield, that's it. What is the ten-year yield today? That is the ten-year forward return. Stocks get dividends, plus inflation, plus real EPS growth (1% less than GDP growth), plus multiple expansion/contraction. Stocks yield 2%, inflation is 2% (kinda), EPS growth is 1% and multiples are likely to fall, so best you can hope for is 5% (and likely lower). Even though we feel good about the process for thinking about future returns, ***"There are more things in Heaven and Earth, Horatio, than are dreamt of in your philosophy."*** We all believe that we can contemplate all the potential outcomes when we make an investment, but the truth is that there are always more scenarios that could play out that you can (or will) consider because of general human optimism (we don't like to consider worst case) or because of the inability to anticipate the anticipations of others. Investing is a complex adaptive system and the decisions of the participants in the market itself influence further decisions and reactions to new information that was not available at the time that you made your original investment. ***"There is nothing either good or bad, but thinking makes it so."*** You have a 50/50 chance in the investing business until you think and then your odds go down. Even the best of the best are right 58% of the time. There is no investment good enough that can't be spoiled by paying too high a price and no investment bad enough that can't be fixed by paying an extraordinarily low price. With most things, investing included, the outcome is judged ex-post and then it is determined if it was good or bad. For example, taking a huge idiosyncratic risk in one stock is imprudent, but if successful (the stock goes up, no matter what the reason), the decision will be viewed (with the benefit of hindsight) as a good plan.

Speaking of large idiosyncratic risks (Debt Bubble), another of the most frequently quoted lines from Hamlet is ***"Neither a borrower nor a lender be, for loan oft loses both itself and friend, and borrowing dulls the edge of husbandry."*** Lending money is fraught with peril, both in terms of losing capital and in losing relationships if (when) things get messy. The other problem is that borrowing money turns people into spendthrifts and they lose the edge of being a good fiduciary with the capital (people take care of money much better when they have less of it). We see this in highly leveraged companies/countries that spend money in frivolous ways versus companies/ countries that are funded more conservatively and know how to stretch a dollar. In the end, people lead/manage companies/countries and not all of them are competent and sometimes (sadly) they have bad intentions too. ***"The Devil hath power to assume a pleasing shape."*** The worst people have the ability (and the incentive) to become the most attractive and convince the unassuming that they are acting in your best interests. We are naturally drawn to their pleasing visage and we let our guard down at precisely the wrong time. Sometimes there are companies/countries that follow bad programs (QE and SVM) that look pleasing to the eye (since they perform well in the short run) and attract lots of "smart" investors into the fold, but in the end, remember there is a Devil underneath and losses are likely to come because ***"Rich gifts wax poor when givers prove unkind."*** No matter how good the gift appears to be when given, if it turns out that the giver has bad motives or is self-interested, the gift (and the repercussions) will be poor indeed.

"Madness in great ones must not unwatched go." The more powerful the position, the more mindful we have to be for signs of madness (or self-interest). When authority figures are so concerned about staying in power that they will say or do anything (even bad things) to stay in power, we should become increasingly wary and defensive. ***"The lady doth protest too much, methinks."*** The more someone tries to convince you of something, the more the opposite is true. When someone has to tell you repeatedly how honest they are, they aren't. When they have to remind you over and over that they have your best intentions in mind, they don't. When a company proclaims relentlessly that their accounting is not aggressive, it is. When a government assures you time and again that they won't default on their debt, they will. So today we have to be wary of the global bubbles being formed by Central Bank largesse, but ***"Though this be madness, yet there is method in't."*** Even when something goes to an extreme that appears to be madness, there is a reason behind it. Soros said that, *"Stock market bubbles don't grow out of thin air. They have a solid basis in reality, but reality as distorted by a misconception. Every bubble consists of a trend that can be observed in the real world and a misconception relating to that trend. The two elements interact with each other in a reflexive manner."* The Reflexivity is the key, what begins as a logical trend begins to elicit behavior that drives the trend to an extreme that appears to be madness. (Reflexivity makes investing one of the most challenging, yet rewarding, intellectual endeavors.)

Importantly, ***"Oft expectation fails, and most oft there where most it promises; and oft it hits where hope is coldest, and despair most fits."*** When expectations for something reach very high levels they are bound to disappoint and, conversely, when expectations are lowest things often work out well. In investing when you are certain something is going to be a winner (particularly when sure it will be a big winner) things don't work out and when you have real doubt and skepticism (particularly when feel really uncomfortable) things work out well. One problem is that ***"When sorrows come, they come not single spies. But in battalions!"*** When things begin to go wrong, they go wrong in bunches. It is like the famous line about cockroaches, when you see one there is never just one, but rather thousands behind the walls waiting to get out. If one company in an industry has abused accounting rules, suddenly you find that many took the same liberties. If companies in certain business observed that one competitor gained an advantage from using leverage, they will all use leverage up until the point that the whole group collapses. This construct also applies to earnings. When a company finally misses earnings for a quarter, they miss again and again going forward (serial autocorrelation) because once the CFO runs out of ways to hit the estimates, they have run out of tricks. Critically, when you find yourself on the wrong side of expectations and sorrows come, ***"Do not spread the compost on the weeds."*** Don't compound your mistakes and turn them into errors by doubling down. Great investors don't feed their weeds, they let their flowers grow (and compost them if possible). Soros claims that he is only rich because he admits his mistakes faster than others (he pulls the weeds quickly).

So what would Shakespeare tell us to do in the current environment? Polonius (father of Hamlet's beau Ophelia) gave some sage advice to his son Laertes that applies, ***"Give every man thine ear, but few thy voice; Take each man's censure, but reserve thy judgment."*** Listen more than you talk for you cannot learn anything new while you are talking and you can learn something from everyone you encounter. Don't judge a book by its cover as appearances can be deceiving and in investing it is often those that appear to have the least importance that have the greatest knowledge (the line worker who sees poor quality controls) and those that appear to be the most important may not even know what they don't know (the CEO who doesn't use his own products). Further, ***"This above all: to thine own self be true, and it must follow, as the night the day, thou canst not then be false to any man."*** Do what is right and bear no false witness to others. Be true to yourself and your core beliefs and don't be swayed by what is popular. Have the courage of your convictions. A final piece of wisdom comes from Horatio when he tells Hamlet that, ***"If your mind dislike anything obey it."*** When you don't like something, don't do it. The good news in investing is that you are never forced to invest and you can listen to that inner voice as long as you want because there are no called third strikes. Wait until the perfect pitch comes along before you swing and then swing big.

So from Shakespeare's Prince of Denmark back to the Artist Known as Prince for some concluding words of wisdom, which seem very important in the investment environment we find ourselves in today. ***"I was dreamin' when I wrote this, so sue me if I go 2 fast. But life is just a party, and parties weren't meant 2 last. I was dreamin' when I wrote this, forgive me if it goes astray. But when I woke up this mornin' coulda sworn it was judgment day. The sky was all purple, there were people runnin' everywhere. Tryin' 2 run from the destruction, U know I didn't even care. Cuz they say two thousand zero zero party over, oops out of time. So tonight I'm gonna party like it's 1999."***

First Quarter Review

We opened this section of the letter each of the last two quarters with a comparison of the equity market activity during the quarter to a roller coaster ride and that analogy continued to apply (with bigger ups and downs) in Q1. So let's review the various thrill rides on the global equity roller coasters over the past three months. In the U.S., 2016 started off with a terrifying decline (worst first five trading days ever to start a year) as fears about China emerged again and we wrote last quarter that January was a real white knuckler (the 9th worst January of all time), saying *"The real thrill ride started the next day and the S&P careened almost straight down for three weeks, falling (11.4%) to an intra-day low on 1/20 of 1,812 when, out of nowhere, some able-bodied Carnie pulled an emergency brake and the coaster surged back upwards 2.5% to close the day at 1,859 and then rose another 4.4% (inclusive of a short squeeze induced up 2.5% on 1/29) to finish the month at 1,940,"* ("only" down (4.9%) for the month). The coaster barely crested the hill to end the month and headed straight down in February hitting a new low of 1,829 on 2/11 (down (10.4%) for the first six weeks) and fear was palpable all over the equity markets. The nice thing about roller coasters is that after every down (no matter how steep and scary) there is an up (and you always end up in the same place in the end) and the S&Peedcoaster 500 careened off the bottom like it hit a spring and surged 12.6% to 2,060 by the end of the quarter (less than 1% from where it began the New Year and nearly exactly the same spot (2,059) it was at the end of 2014). From that beginning point, it was time to head back up the chain lift and we ramped back to 2,102 on 4/20 (only a few points below the peak from 5/1 of last year at 2,131) to start the fun all over again and then we headed back down (2%) during the last week of April to finish the month nearly right where we started, at 2,065, setting up nicely for the "Sell In May And Go Away" (#SIMAGA) trade (why yes, it is beginning to feel like Groundhog Day).

Looking at the Eurocoaster, we wrote last time that *"Perhaps someone knew that Super Mario Draghi would (once again) say he would "do something" on 1/22 and extend the ECB QE Program beyond 2016, or perhaps it was Pierre Andurand switching from Bearish to Bullish on Oil on 2/10 (allowing oil to find a temporary bottom at $26.55 and surge 26% over the next week), but clearly something changed and the panic subsided (at least temporarily)."* But whatever it was the Euro Stoxx 50 bottomed the same day as the S&P 500 on 2/11 after having fallen a terrifying (18%) to 2,680 from 3,268 to start the year. Normally with roller coasters the larger the drop, the bigger the ascent on the other side, but European equities didn't follow that blueprint. We had mentioned in the last letter that *"With two double digit drops and a double digit decline over the three months, something doesn't seem right on the European track,"* and the Index only rallied back 15.4% to 3,092 on 3/14, well short of the 12/31 levels and actually headed back down to finish the quarter at 3,005, down (7.7%) for the quarter (those returns are in Euro, the MSCI Europe Index was down only (2.5%) in USD). The thrills weren't over yet and the cars sped down some more in the first week of April to hit a low of 2,872, careened back up to 3,152 two weeks later and headed down in the last week to finish at 3,028, down (6.7%) for the CYTD. On the Eurocoaster, the ride around to the same place has been going on for even longer than in the U.S. as the Euro Stoxx 50 Index is not only at the same level it was to begin 2014, but the ups and downs over the past five years have delivered the cars back to almost the same spot as where they started on 5/1/11 at 3,009 (while there has been some return from dividends, the price has been the same for half a decade).

We described the Samuraicoaster as a *"truly motion sickening"* ride last quarter as Kuroda-san's unwillingness to increase the QQE program triggered a massive descent in early January, but the Japanese equity markets were actually beginning to recover in the last week in January until the BOJ Governor shocked the world by stealing a page from the Draghi Coaster blueprint and initiated a NIRP on 1/29 (after vehemently denying that he would do so just a week earlier). The Nikkei immediately plunged a frightening (16.3%) from 17,865 on 2/1 to 14,952 on 2/12 before careening off the bottom along with all the other global equity coasters. Like Europe, the Japan Index surged over the next month to a peak of 17,234 on 3/14 (a solid 16% increase), before turning back down to finish at 16,759, down a scary (11.9%) from 19,034 to start 2016 (those returns are in Yen, the MSCI Japan Index was only down (6.5%) in USD). April was the whoop-de-doo section (a moto-cross term for a series of sequential bumps) and the Nikkei dropped to a low of 15,715 on 4/6, surged back to a peak of 17,572 (up 11.8%) on Earth Day (4/22) and finished at 16,666 (a very ominous number for you numerologists), modestly below where it started after collapsing (3.6%) on the last day of the month when Kuroda-san sat on his hands again (some might say his hands were tied) with respect to more stimulus. After being one of the best performing equity markets since 2012, the Samuraicoaster is now resting at the same spot as it was at the beginning of November 2014, right after the big Kuroda Halloween Surprise when he expanded QQE for now what appears to be the last time. There are many theories of why the Bank of Japan ("BOJ") has been hesitant to buy more securities in the markets, but perhaps the simplest explanation is that they already own 1/3 of all the Government Bonds (JGBs) and 1/2 of all the ETFs in Japan.

The wildest roller coaster ride (by far) over the past five years has been in Emerging Markets where the scrEEMcoaster had made a series of six wicked drops and recoveries from May 2012 to May 2015 to wind up in the same place only to careen down in a harrowing (34%) collapse from 43.02 to 28.45 on 1/15 this year (one could have made the #SIMAGA trade any of those Mays and been better off). But something changed in the middle of Q1 as the U.S. Dollar peaked, Oil began an epic rebound off the $26.21 low on 2/11 and EM equities began to surge all around the world. From the mid-January bottom, EEM has surged back to 34.25 to end the quarter and then followed the rest of global markets lower in early April before jumping back up to 34.39 to finish the month. Emerging markets are nicely ahead of developed markets for the CYTD now and while there is still a lot of ground to make up to get back to the highs of last year, there is now a very different rhythm to the scrEEMcoaster than the other global equity thrill rides. Even the wildest ride of them all, the Dragoncoaster in China, seemed to settle in nicely to the chain lift after the gut wrenching drop during January that we described last quarter, saying, *"Just when things were looking good for Shanghai riders, the PBOC suddenly moved the RMB peg ever so slightly (only about 1%), but investors panicked and the coaster swooped downward a truly frightening (27.3%) over the next five weeks to trough at 2,656 on 1/28. The SHCOMP did actually participate in the 1/29 global melt-up and rose 3.1% back to 2,738."* With some volatility, the Chinese Index rose steadily over the course of the past three months to finish April at 2,938, up 7.3%. Since we are talking about carnival rides, it seems fitting that we talk briefly about Brazil. The Canarinhocoaster (little canary for the iconic yellow futbol jerseys) that is the Ibovespa Index had plunged from 58,052 last May to 37,497 (down (35%) in eight months) at the end of January this year, just days before the annual Carnival was set to begin the first week of February. Despite the fact that the Brazilian government cancelled Carnival due to the ongoing economic (and political) woes, the equity market caught the chain lift and never looked back, rising an astonishing 44% all the way back to 53,870 at the end of April. While those returns are in local currency, and the Real has been punished over the past few years, the MSCI Brazil Index was up a stunning 28.5% in USD in Q1 and is now up an even more impressive 41.5% CYTD through April.

The roller coaster ups and downs of the global equity markets over the past year might trigger a sense of déjà vu when looking at the ride of the various equity markets above, but that feeling grows very strong when we look at just how similar 2016 has been to 2000 in the U.S. equity markets. Leaving aside (for now) comparisons of both years being election years (and the special 8th year of the seated President), the S&P 500 has been following a path incredibly similar to late 1999 and early 2000. In our original #2000.2.0 scenario we had laid out how 2015 was looking a lot like 2000 and 2016 might play out like 2001, but the weight of the data now shows that the period from mid-2015 to today looks extremely similar to mid-1999 to April 2000. From June of 1999 to April of 2000, the S&P 500 roller coastered between down (10%) and up 10% and was up 7% for the trailing ten months, while NASDAQ had just released from the largest chain lift rise ever (up 90% over five months from October to March) and was just starting the huge downhill run that would take the tech-heavy index down (78%) over the next 30 months, but was still up 45% for the ten months. One thing of particular note was that the NASDAQ Index was dominated by four stocks MSFT, CSCO, INTC and ORCL with market caps of $520B, $470B, $400B and $230B, respectively (25% of entire index market cap). While MCIO is not nearly as catchy as FANG (Facebook, Amazon, Netflix and Google), the construct is the same, the market advance had become incredibly narrow at the peak. Looking at the period since June 2015 to today, the S&P 500 roller coastered between down (11%) and up 3% and is flat for the trailing ten months. One thing that is not exactly the same this time is that the NASDAQ Index has tracked the S&P 500 more closely (actually down (5%) over last ten months), but the FANG stocks caught the chain lift in late 2015, rising between 40% and 60% and are currently up about 30% on average over the past ten months. While the FANGs are not the absolute largest, three of them are in the top ten and they have exhibited the same type of cult-like following in recent years as investors will seemingly pay any price to own them (just like in 2000).

Looking at just 2000, the S&P 500 had been down (8%) in February, had rallied back to be up a few percent and limped into May 1st down a little less than 1%. NASDAQ, on the other hand, had surged 24% by the fateful day of March 9th before heading south and was actually down (5%) through April. This was the last chance to get out whole before the monster drops occurred over the ensuing three years and sell in May and go away was really good advice. So far in 2016, the S&P 500 was down nearly (10%) in mid-February, then rallied back to up a few percent, but also limped into May 1st up around 1%. NASDAQ had no similar rally to 2000 and was in fact down almost (15%) before climbing back to end up at the same place as April 2000, down (5%). The FANGs have fared no better and are also down (5%) on average. While FB blew out Q1 earnings and rallied from a (6%) deficit early in the year to finish up 12%, NFLX missed Q1 subscriber growth and fell (20%) in mid-April to finish the first four months down nearly (22%). The story is yet to be written as to whether sell in May and go away will once again be good advice, but given the high valuations, declining profit growth and uncertainties about global growth and interest rates, we would err on the side of caution right now. The other issue of concern relates back to the election year cycle and how the eighth year of a sitting President has been a treacherous time for investors in stocks. Since 1900, there have been six occasions where there has been an eight year term and five of the six produced negative returns for the year, averaging down (14%). Interestingly, the average profile of those six periods shows that the equity markets struggle in Q1, recover back to nearly flat by May and then lose the (14%) over the course of the summer, through the election and into the end of the year. Furthermore, there is no normal Santa Claus rally in these years. These poor returns are in stark contrast to normal election years when equities essentially mark time from January to August (assessing the likely victor) and then surge higher over the last five months to finish up 8% on average (an amazing (22%) performance gap for those keeping score at home with an 83% hit rate).

If we take a closer look at performance within the U.S. equity markets in Q1 from a size and style perspective, the slightly positive outcome for the overall market (the S&P 500 Index returned 1.4%) seems to mask the growing weakness within certain segments of the market. Performance was quite mixed in Q1 as large-cap growth stocks (Russell Top200 Growth Index) gave up the mantle of leadership, rising a scant 0.8%, and passed the baton to the mid-cap value sector where the Russell Midcap Value Index rose a robust 3.9%. On the low end of the liquidity spectrum, small-cap stocks (R2000) underperformed overall, falling (1.5%), but the performance was polarized as small-cap value stocks (R2000V) rose 1.7%, while small-cap growth stocks (R2000G) struggled, falling (4.7%). We wrote last time that, *"The R2000 was noticeably weaker in the last two months of the year and was actually down (5%) in December (that weakness in lower liquidity names was certainly a harbinger of things to come in the New Year),"* and the early weakness in broad markets could certainly have been expected given the slump in the less liquid names. Taking that point to the extreme, the micro-cap stocks were the worst performers in Q1, dropping (5.4%) for the quarter and (13.1%) for the trailing year (compared to a positive 1.8% for the S&P 500). We mentioned in the last letter that, *"The huge spread between large-cap growth (up 8.2%) and small-cap value (down (7.5%)) indicates that there is significant stress in the equity markets and that a defensive posture would be advisable in the months ahead,"* and that turned out to be a prescient warning for the first half of Q1, but less so in the second half. So far in 2016, the growth/value dynamic has been very confusing as there was essentially no difference in the large-cap segment, while in the mid-caps and small-caps, value turned around and beat growth. The primary reason for the change is the recovery in commodity-related names this year after oil began to recover in mid-February. It is possible that there is a meaningful shift underway in global equity allocations to favor more value and cyclical names. While this shift doesn't fit exactly with a slowing global economy and stress in the financial sector, we feel this trend will be worth monitoring very closely in the months and quarters ahead.

When looking at the performance of the sectors of the S&P 500 it seems odd that eight out of ten sectors outperformed the Index and the top two sectors, Telecom and Utilities, were both up double digits (up 16.6% and 15.6%, respectively) yet the S&P 500 was only up 1.4%. This outcome points to the fact that not all sectors are represented equally in the Index. Telecom and Utilities are only 2.8% and 3.4% of the Index, respectively, while the two laggards during Q1, Healthcare, down (5.5%), and Financials, down (5.1%), are 14.3% and 15.6% of the Index, respectively. We wrote last quarter that, *"Most importantly for the sector data was the shift in momentum in December when all of the Defensive sectors were back on top with Staples, Utilities, Healthcare and Telecom rising. That trend was exacerbated in January as the Bulls lost control of the equity market and the Defensive sectors surged while the Growth sectors were severely punished."* That trend continued in Q1 as three of the top Defensive sectors rallied hard (Staples were up 5.6% to go along with Telecom and Utilities) and only Healthcare failed to provide its usual protection as continued fallout related to the Valeant drama and a sudden crackdown on tax inversions by the Obama Administration caused meaningful losses across the board in healthcare. One other notable development was the surge in commodity related sectors after 2/11 and Industrials finished the quarter up 5%, Energy rallied 4% and Materials rose 3.6%. There is significant momentum in this trend as the Dollar continues to weaken, but any change in Dovish tone from QEeen Janet will take the air out of the commodity recovery in a hurry. Technology and Consumer Discretionary also beat the Index in Q1, rising 2.6% and 1.6%, respectively, with all of the gains coming in March as frenetic short covering occurred in the last six weeks of the quarter and the most heavily shorted names surged more than 30% off the February trough.

Coming into 2016, there was near unanimity (usually a great contrarian indicator) that King Dollar was headed higher and that emerging markets currencies (particularly the Chinese RMB) would continue to plunge. We noted, however, last time that, *"For all the* *talk about the strength of the U.S. Dollar in 2015, there has really been almost no movement in the DXY Index since the massive 9% gain in Q1. DXY fell (2.5%) in Q2 managed only a scant 0.8% in Q3 and finished the year with a 2.5% gain,"* which we believed implied a higher likelihood that the Dollar had peaked and would head back down in 2016. Perhaps our favorite MCCM Surprise was #8 (*King Dollar Dethroned*) where we made the case that there were far too many investors on the same side of the USD trade and there was a great deal of misunderstanding about the intentions of the PBoC to create a very stable RMB so that their plan to have the Yuan included in the SDR portfolio could reach fruition in 2016. We also wrote that, *"The Dollar decision will continue to be critical as the Central Bank drama unfolds and we will see in the coming months whether the intention of the Fed to diverge from the easing path of the ECB and BOJ is achieved or whether the overall global malaise pushes the Fed to reverse course and continue the stimulus of the past six years."* Our view, as expressed in MCCM Surprise #2 (*Two Wrongs Won't Make It Right*), was that the Fed would realize the error of their decision to hike in December and would not raise any more in 2016, thereby providing a tailwind for further Dollar depreciation in the New Year and relieving much of the pressure on the Chinese to devalue the RMB. So far, so good, on the Fed but what we didn't anticipate was how the BOJ and ECG would cooperate as well by not increasing stimulus, thereby triggering even greater weakness in the Dollar (or rather, strength in the Yen and Euro which achieves the same purpose). If the Dollar continues to languish for the balance of 2016, we believe the trends in emerging markets equities, commodities and currencies could accelerate rapidly over the course of the year.

As the second half of MCCM Surprise #2 we noted that it was possible that the Fed would have to not only put off any rate hikes in 2016, but by the 2H16 would have to reverse course from the December tightening and begin easing again (how they would ease we were not quite sure since they seemed to be running out of bonds to buy with QE and they are prohibited by law from buying stocks, for now anyway). We have described on many occasions over the past few years the strong linkage between Fed bond purchases (QE) and subsequent increases in U.S. equity markets. We have referenced the great work done by Larry Jeddeloh of TIS Group on this topic, and discussed how he had shown that, "*historically every $100 billion of QE has translated into 40 S&P 500 points."* We have also written in the past that, *"When Ms. Yellen said that the Fed would cease the QE Program in the U.S., we asked an important question in our Q4 2014 letter; given U.S. equity markets have been driven by the QE equation since 2009, the cessation of QE this month does beg the question of what happens in 2015? The larger question is, again, how would equities continue to rise?"* With the actual results for 2015 and Q1 2016 now in, we have the answer: they won't. Other than a couple percent of dividends paid, the S&P 500 Index is almost exactly where it ended 2014, and with increasingly poor performance coming in from corporate earnings and GDP growth (Q1 first estimate at 0.5%), there is likely to be more downside in the equity markets, so we will see if the Fed truly has a third mandate (beyond their stated mandates of employment and inflation) to keep the equity market stable. The Fed talked tough about keeping the door open to a rate hike in June but if the #SIMAGA summer doldrums hit and equities fall, expect much backtracking and eventually the discussion of QE IV (or some new plan, like repealing the law against Fed equity purchases so they can be like the BOJ and SNB). While we are talking about the Dollar, there are a handful of developed markets (the rest of the EAFE Index) that always get overlooked in these letters, as they are not covered in the Europe or Japan sections, but they have one thing in common, a historically strong correlation to commodities (their FX are even called commodity currencies). Canada, Australia and New Zealand are relatively small markets and normally don't warrant much attention, but in Q1, their currencies turned around sharply and their equity markets rose 11.3%, 2.1% and 11.6%, respectively. There will likely be some interesting opportunities in these markets if Dollar weakness persists, so perhaps we will have more to write about them in the coming quarters.

Looking across the pond at the European equity markets, it was pretty rough out there in Q1 as every market suffered significant losses measured in Euros. With the benefit of the surprise 4.8% depreciation of King Dollar against the Euro, four of the fifteen markets managed to generate positive returns in Dollar terms as the Netherlands was up 3.4%, Portugal was up 3.2%, Norway was up 1.7% and France eked out a 0.1% gain. Even with the Euro tailwind, the losses in some countries were quite large with Spain falling (4.1%), Switzerland down (5.5%) and Italy slumping (11.7%). The shocking strength of the Euro was a benefit for U.S. investors abroad and actually played out in a manner similar to what we described last quarter when we wrote, *"All throughout the year Mr. Draghi did his best to devalue the European currency (essential to keep the Mercantilism dream alive), but perhaps the lack of a true monetary union in Europe limits the effectiveness of the Central Bank (relative to the BOJ and Fed), or perhaps there is some "Central Bank Fatigue" coming to the fore around the world, or perhaps the stimulus only works in the equity markets if the money actually finds its way into stocks."* Clearly Super Mario's constant refrain of "whatever it takes" is beginning to resemble the little boy who cried wolf, as it seems that all of the ECB activity over the past year has been generated very little benefit (either for economic growth, the creation of inflation, or stock prices). Last summer we tried to quantify the impact of ECB bond purchases on equity markets in a similar manner to the TIS Group calculation for QE and the S&P 500. After a couple of revisions to the thesis, we came up with what appeared to be a reasonable formula and wrote, *"Looking back, it is clear that the ebullience right after the ECB announcement skewed the data and with nearly a full year of asset purchases completed we can recast the formula that for every 100B Euro of purchases you get 20 Euro Stoxx 50 points (significantly smaller than the original calculation). Given that Super Mario has recently reaffirmed his commitment to the bond purchases at 60B Euro a month through (at least) March of 2017 that would equate to roughly 140 Euro Stoxx 50 points for 2016, only a 4.3% increase (not very super at all)."* However, with a third of 2016 now behind us, it appears that the construct that Central Bank effectiveness is waning is firmly in control, as we should have seen a gain of 50 Euro Stoxx 50 points by now, yet we stand at 3,009 on 4/30 and have actually lost 259 points from the starting point of 3,268. While there is plenty of year ahead, the likelihood of the Euro Stoxx 50 surging 400 points from here (up 13%) seems reasonably unlikely, so it appears we will need another revision to our model.

Turning our focus to Japan, one of our Ten Potential Surprises for 2016 focused on the Yen and the Nikkei and pointed to the key role that BOJ Governor Kuroda would have to play for in order for Japan to remain the Land of the Rising Stocks. We wrote, *"Surprise #3: Save Us Kuroda-san. You're Our Only Hope. BOJ Governor Kuroda surprises everyone at the end of the Japan Fiscal Year and pulls out another bazooka to weaken the Yen and stimulate the economy and markets. The Yen falls dramatically, with USDJPY hitting 135. Corporate profits surge to new record highs and Japanese equities rally hard, finishing the year at 21,000."* The Japanese equity market remained cheap relative to other developed markets coming into the New Year and the Yen looked set to weaken more in 2016, so we were fully expecting to see continued strength in the markets. Unfortunately, not even attractive relative valuations could help the Nikkei in January as the global equity market meltdown turned the Yen into its historical safe harbor role and the USDJPY surged from 120 to 117 by the third week of the year, pulling the Nikkei down (15.8%) at the nadir on 1/21. Then the unthinkable happened. We wrote about the stunning (although less stunning as details leak out about the #ShanghaiDetente) about face by Kuroda-san last time saying, *"Then, in a surprise move on the last day* *of January, Kuroda-san shocked the world with a Negative Interest Rate Policy (NIRP) to try and force the banks to lend excess reserves into the economy and "break the grip of the deflationary mindset."* That surprise set off a massive selling spree of Japanese equities by foreigners and a huge short covering rally in the Yen as the Nikkei slumped to 14,953 on 2/11 (entering Bear Market territory, down (21.4%) for the CYTD) and the USDJPY surged to 113. Things were looking very dark in equity markets all around the world and then as sharply as markets had fallen, stocks began rising and the Nikkei rallied back to 16,759 to finish "only" down (12%), but the Yen strength helped U.S. investors loss a more modest (6.5%) in USD.

We wrote last quarter how, *"Kuroda-san loves the element of surprise and we would expect to see one more surprise (more QQE) up his sleeve as the fiscal year end approaches in March."* However, as it became increasingly more apparent that a Détente was called in the global Currency Wars during the Shanghai G20 meeting, our confidence in any further easing by the BOJ in the near term deteriorated. The rest of the world, however, was seemingly still holding out hope that Kuroda had found a new bazooka, because when he failed to increase QQE on 4/28, Japanese equity markets collapsed (3.6%), the Yen surged 2.5% and there appears to be more damage likely to come when the markets reopen after the National Holidays in early May. One interesting development that bears watching is that after some meaningful collateral damage to the mega-banks after the NIRP decision, SMFG and MTU rallied a stunning 35% off the bottom on 2/11 and are still up 20% and 18%, respectively, after the turmoil of the last couple of days (as of April 30, compared to the Nikkei up only 11%). Our favorite Japan managers have shared some frustration with the recent series of BOJ decisions, but have become increasingly excited about forward looking returns in Japanese equities despite the headwind of recent Yen strength. They continue to point to rising ROEs and, as we discussed last quarter, *"a newfound appreciation by Japanese management teams of Stock Buybacks and the continued unwinding of cross shareholdings,"* that should help the Japan Bull Market regain its footing. It takes some strong conviction to be supportive of Japanese equities with the Yen crashing to 106.5 and earnings estimates coming down, but at least the earnings growth is positive (which is better than the other Developed Markets) and valuations have fallen back to levels described as "stupid cheap" on a recent call with a very experienced Japan specialist.

Emerging and Frontier Markets have had a very tough five years, but that said, we began to make the case over the last couple of letters that the time could be coming to buy "what is on sale" in EM. Last fall we said, *"We could hear Sir John Templeton's words "Bull Markets are born on Pessimism" and we can feel that pessimism in the markets. Sir John says to buy at the point of "Maximum Pessimism" and we might not be there just yet, but we are likely getting close."* In Q4 of last year the collective pessimism of the markets toward EM was nearing a crescendo and we wrote in January that, *"we are reminded of another great quote from legendary investor George Soros who says, "The worse a situation becomes, the less it takes to turn it around, the bigger the upside." There is likely one last cathartic move down, but we are also more likely to be closer to the end of this down cycle in EM than the beginning."* Emerging Markets may have indeed reached their nadir in Q1 as the more dovish language from the Fed and the reduced stimulus from the BOJ & ECB resulted in a Dollar peak, and an oil surge an EM equities caught the chain lift and rode nearly straight up off the bottom in mid-February. In March alone, the MSCI EM Index was up 13.2% to erase all the losses from the first six weeks of the year and finished the quarter up 5.7%, well ahead of the Developed Markets. One of the early signs of recovery in EM came in Asia when a few of the most beaten down countries surged in Q4 after the Fed made dovish comments about the pace of rate increases and we wrote, *"The most extreme example was Indonesia, which was the strongest performing EM in Q4 rising a very robust 20.8%, but the damage* *of the first three quarters was huge, so the market was still down (19.5%) for the year. Malaysia was another market where currency losses had beaten down equity markets during the first three quarters and a strong 7.9% rally in Q4 brought returns to down "only" (20.1%) for 2015."* The surge continued for Indonesia and Malaysia in Q1 as they climbed another 11.2% and 13.2%, respectively, and only Thailand was up more in India, rising a very robust 16.9%. Unfortunately, not everyone in Asia got the rally memo and India fell (2.5%) on continued concerns about the pace of reforms (although MSCI India did rally 13.1% in March) and China continued to lag (more on that below).

One of the areas that fared the worst in 2015 (and over the past few years) was Latin American and we wrote last quarter that, *"LatAm countries did not fare as well during Q4 and the negative equity and currency trends actually accelerated downwards resulting in some truly terrible performance."* Re-reading this line made me think of the great quote from Arjun Divecha (the EM portfolio manager at GMO) that, "You make the most money in Emerging Markets when they go from truly awful to merely bad," and that mantra proved profitable again in Q1. Latin American markets caught fire as political upheaval in Brazil signaled that the worst might be in the past, the recovery in oil sparked rapid gains in Columbia and Mexico and just when things looked like they couldn't get any worse, they actually didn't and markets soared. The MSCI Latin America Index surged 19.1% for the quarter and while Mexico was the laggard at only up 8.5%, Columbia jumped 22.5% and Brazil soared an astonishing 28.5%. As the debate raged on whether the Brazilians will actually impeach President Rousseff, the economy plunged deeper into the worst Recession since the Great Depression and rumors circled of the collapse of the Real from 4 to as high as 8 (to the Dollar). The Ibovespa did what equity markets do best sometimes and climbed the wall of worry. As of the end of April, the Brazilian equity market has jumped another 11.4% to be up over 40% CYTD and the Real has strengthened sharply to 3.5, defying all the negative forecasts from the beginning of the year.

We discussed last quarter how the strong Dollar was hurting EM currencies and that much of the losses in the EM equity markets were actually currency losses rather than equity declines. We commented that, *"The country most negatively impacted by continued currency weakness was South Africa, which fell another (10.6%) in Q4 to finish 2015 down (25.5%),"* and as you might expect, there was a lot of pent up energy in this market waiting to be unlocked by a slowdown, or better yet, a reversal, of the Dollar strength. There were also a ton of hedge funds that had piled on the short EM FX trade toward the end of 2015, some as a directional play on the Dollar strength and some as a proxy for the RMB short which had become very expensive to transact directly as the Chinese fought back in the FX markets. All of the negativity toward EM currencies turned with a vengeance in mid-February, and March was an epic month for EM currency returns as a massive short squeeze ensued and countries like South Africa had huge convexity to the move, rising 17.9% in March and finishing up 13.8% for Q1. We also commented last time that, *"The only place within EM where there were a small number of bright spots was Eastern Europe. Hungary had a fantastic quarter and year, rising 11.4% and 36.3%, respectively, and Russia confounded the skeptics that assumed that market would struggle in a year where oil fell so dramatically, having a tough quarter, down (4.1%), but managing to have a solid year (compared to other developed markets), up 4.2%."* Eastern Europe enjoyed more strength in Q1 with Hungary rising 17.3%, Turkey surging 21.6% and the MSCI EE Index jumping 15% overall. Russia added to their gains in Q1, particularly in the second half of the quarter, mirroring the oil recovery, and while the MSCI Russia Index was up 15.8%, there were some individual companies that did even better including Sberbank, which soared 40% for the quarter (after being down (25%) for the first three weeks, which makes it an 87% jump off the bottom). The only dark spot in EM was once again Greece, as uncertainty about the Debt restructuring led to wild volatility and the Index fell (12.2%) even after an astonishing 23.9% jump in March. There will come a time to buy stocks in Greece again (as assets are just too cheap) and that time may be approaching faster than most anticipate.

China continues to be the most discussed economy and market in the world. So many prognosticators and pundits have staked their reputation on the fact that all the data coming out of China is fake and that China is headed for (the most strident will say is already in) a Hard Landing and a collapse of their currency and equity markets. Some will even go further and say that their entire financial system will implode, resulting in social unrest and a meltdown of their society. Extreme points of view make good media headlines, but rarely come true, so we will take the under on the total Doomsday scenario. Not that there are not potential problems to be addressed in China, there are, but we believe that the current Leadership has a robust long-term plan for managing the transition from an industrial economy to a consumer economy over the coming decades. So from the 30,000 feet view back down to the ground level view, in Q1 the MSCI China Index struggled through some tremendous volatility and finished down (4.8%) while the MSCI China A-Shares 50 Index fell even more, declining (10.1%). The early declines resulting from another shot across the bow from the PBoC on moving the RMB Fixing upwards (partially revaluing the Yuan) in January were just too much to overcome despite very strong moves by the indexes in March, rising 11.9% and 10.5%, respectively. The fears of an RMB Devaluation are palpable and we wrote last quarter that, *"Most prognosticators will simply say that the rest of the devaluation is coming imminently, so investors should avoid investing in China. We can find lots of very smart managers who have made big bets against China and the Chinese currency (largest being the recent report that Hayman has 85% of their capital positioned short China and HK equities and currencies)."* Our view is that this trade has become consensus and one thing we have observed over the years is that markets rarely take the path of least resistance, but rather take a path that inflicts maximum pain for the majority of investors. We just did an *Around the World with Yusko* (#ATWWY) Webinar last week titled *Yuan a Piece of Me? China Plays Hardball with the Hedgies* where we laid out a case for why there would be no RMB devaluation this year and that the hedges against that event will turn out to be an inefficient use of capital.

We went further last quarter in saying, *"We continue to take the glass half full view, and with the further correction in early 2016, the CSI300 Index fell back toward 9X forward EPS, which has historically been a very good buying opportunity for long-term investors."* Although the Q1 returns have not been very strong (translation, we were early) there is a lot of year left and we will have to wait and see if our early turns out to be the euphemism for wrong. When we wrote the Q4 letter at the end of January, we said that, *"While the early 2016 returns in China have been poor, on the eve of the lunar New Year, the forecasts for the Year of the Monkey indicate that there will be a meaningful rally in the Chinese equity markets in the second half of the year."* Again, time will tell us if those forecasts turn out to be accurate; in the meantime, we have made a commitment to maintaining a long-term focus in China recognizing that a powerful shift toward consumption in a country of 1.4 billion people will take some time, and a long-term perspective is essential for capitalizing on some of the best investment opportunities available in the coming years. We continue to see tremendous opportunity in Chinese equities for the coming decade and we will remain focused on the five core sectors that dominated in the U.S. during our own transition from Industrialization to Consumerism: technology (e-Commerce), retail, staples, healthcare and alternative energy. We said last time that, *"(quoting) Sir John Templeton again, "Bull Markets grow on Skepticism" and with the rampant skepticism amongst global investors on the prospects for China, we see plenty of fuel to feed this nascent Bull Market and help it grow* *over time as the elements of the Third Plenum continue to play out."*

Frontier Markets had a mixed Q1 as the MSCI FM Index limped in with a (0.9%) decline. There were a few pockets of strength, again primarily in Eastern Europe as Estonia rallied 14.8% and Ukraine rose 10.8%. Some of the recent FM darlings had a very challenging Q1 as Pakistan stumbled to a slight (0.7%) decline and Sri Lanka fell precipitously, finishing down (14.7%) for the quarter. These markets are not very deep, or very liquid, so the quarter-to-quarter volatility can be quite extreme. In Africa, returns were mixed as Kenya continued to make positive strides, up 7%, while Nigeria suffered from political and currency challenges related to the decline in the price of oil. As we discussed last quarter, Argentina has been one of our favorite markets over the past year as the potential for a new government, settlement of the hedge fund holdout issue and a growing movement for increased internationalization within the country itself pointed to myriad opportunities to make money in the coming years. With the surprise election of Mauricio Macri as President, we discussed how the equity markets had followed an unexpected path saying, *"Interestingly, the Argentine market followed the 'buy the rumor, sell the news' path and there was some consolidation of gains after the Macri victory in December. Despite the volatility, Argentina was one of the very best performing markets in the world in Q4, surging 25.7%, leaving the market roughly flat for the year. We expect continued gains in Argentina in the New Year as the hold out issue is settled and markets recover from the post-election currency devaluation that sets the stage for a very robust economic and market recovery in the coming years."* Indeed the hold out issue was resolved, further progress was made on a number of political and economic fronts and the Argentine equity market returned a very solid 8.4% for the quarter. Given the long history of unpredictable behavior in the global capital markets, investors are still hesitant to make meaningful allocations to Argentina, which we believe will extend the opportunity and we expect to see continued gains in this market for many years to come.

U.S. Fixed Income markets had a very robust Q1 as early volatility in equities led investors to embrace the safe haven nature of bonds (particularly Long Treasurys) and the Barclay's Aggregate Index was up a very robust 3% for the quarter and the Barclay's Long Treasury Index surged an amazing 8.2% again confounding pundits who continue to be convinced that the big rate increase is just around the corner and bonds are going to get crushed any day now. Even with the Fed doing their best to try and convince the world that they are serious about raising rates, investors essentially ignored, *"QEeen Janet finally doing her best Lucy Van Pelt and pulling the liquidity football away with a 25 basis point increase in December,"* decided that it was a policy error that would be corrected in the New Year and went back to buying bonds. We said in the January MCCM Surprises #2 (*Two Wrongs Won't Make It Right*) that QEeen Janet would channel her inner dove and not raise rates in 2016. Two FOMC meetings down and so far so good on the no rate hikes construct. Clearly there is a lot of 2016 left and the Fed has tried to keep the fear alive each meeting so that the bubbles they are trying to blow in financial assets don't get out of hand, but we see nothing that changes our view that the Fed missed their window to raise rates in 2013 and is more likely to have to ease again before they tighten, which will make bond (particularly long bonds) a killer investment in 2016.

Looking at other fixed income markets, the investment environment in Q1 was very robust for bonds as dovish rhetoric from the Fed led to a falling Dollar, which translated into strong returns for U.S. investors in international fixed income. The Barclay's Global Bond Index surged 6.7% for the quarter, primarily on the weakness of the USD relative to JPY and EUR. In contrast, the JPMGBI was down (2.6%) last year with the bulk of the loss resulting from the currency losses due to the strength of the Dollar. Other credit markets were equally robust in Q1 as the

Barclay's High Yield Index jumped 3.4% as credit spreads contracted and the fears about the "Third Avenue Freeze Out" from last year was so "last year." There were record inflows into HY bonds in Q1 which has historically been a contrarian indicator for future returns and we would expect that trend to continue as we agree with Uncle Carl Icahn that there is Danger Ahead in high yield bonds and even made MCCM Surprises #10 (*The Bus Stops Here*) an homage to Carl's analogy of the free money party bus careening over a cliff and landing on a "Big Black Rock" (his analogy for the potential for huge damage from Blackrock's dominance in ETFs which Icahn believes reduces liquidity). One area where we thought enough correction might have occurred was in the energy space, and we wrote, *"As oil prices went into full Bear mode later in the year, the losses accelerated and the potential for impairments, and ultimately, losses grew rapidly. However, as we begin 2016, it appears that we are getting very close to those fire-sale prices and it may make sense to begin nibbling on a few issuers where there are good assets trapped in a bad balance sheet and we have begun to explore ways to have fresh capital available to capitalize on those opportunities."* Energy HY spreads did indeed peak in Q1 and there were some great opportunities to buy good assets at fire sale prices. The best prices may be gone, but there are still plenty of opportunities in this sector. The JPM EM Bond Index rose another 5.9% in Q1 and continued to solidify its role as a safe haven for global investors in search of yield. We continue to believe that over the long run what we wrote last time about bonds will hold true in saying, *"The challenge of owning bonds in the current environment is that three things can happen and two of them are bad; 1) you hold them and inflation chews up your returns because yields are so low, bad, 2) you hold them and rates rise and you actually lose money, worse, 3) you hold them and rates fall and you make money, good (but then we may have other issues to deal with since falling rates are a sign of economic weakness)."* Holding some Long Treasurys as a Deflation hedge is a different story, but core fixed income is likely to prove to be a very unattractive asset in the years ahead.

2015 turned out to be the year of divergence in the yield asset sector as REITs had another solid year while MLPs were a total disaster. As we began 2016, those trends remained in place. REITs continued to surge and MLPs continued to plummet. An observation we wrote about last quarter was that, *"The surprising part is that it might seem safe to assume that assets which investors purchased primarily for yield would move together depending on the rate environment (would rise with falling rates and fall with rising rates). The breakdown in that thesis is that the source of the yield may be impacted by different elements of the environment and an asset could not follow the pattern in the event that business fundamentals changed more rapidly than the change in the rate environment."* Not all yield assets are created the same and factors such as leverage, structure and underlying asset quality can generate wildly different returns in assets that many investors consider to be comparable. The S&P U.S. REIT Index continued its winning ways, rising 6.3% in Q1 and while all of that gain was compressed into March (up 10.5%), REITs held up better than traditional equities during the deep drawdown in the early part of 2016. Interestingly, REITs have outperformed equities over most trailing periods during the past twenty years, so perhaps there is something to this yield construct after all. On the negative side of the ledger, however, the Alerian MLP Index shed another (4.2%) in Q1, despite a robust 8.3% return in March. We wrote in January that, *"MLP losses accelerated into year-end and continued unabated in the New Year as the selling pressure has intensified and hydrocarbon prices continued to fall. As we said last time, "there are some great assets being thrown out in the oily bathwater, but also some assets that should never have been put into the MLP structure (more cyclical businesses) that will likely fall much further," and it appears that investors are not yet ready to differentiate between the two."* We expected that prices would continue to fall as long as there was pressure on oil and gas prices, but we fully expected that there would be some great assets to buy when (perhaps, it seemed more like if back then…) commodity prices stabilized. We wrote specifically that, *"There will be some generational opportunities in this space in the coming months, but trying to catch falling knives is a dangerous sport and the best strategy is to let the knife hit the ground, bounce around a bit, come to rest and then go pick it up by the handle (lose fewer fingers that way)."* It appears that the knife has indeed hit the floor and stopped moving as there have been some impressive moves from the trough in early February with names like ETE, PAGP and WMB up 125%, 75% and 50%, respectively, off the lows (but still barely back in to the green CYTD). There will be much more opportunity in this area as investors sort out the winners from the losers for the long-term. Focusing on core mid-stream assets should be a very productive strategy as energy markets stabilize and begin to return to more normal operations.

Commodity markets have been caught in a bruising Bear Market since August 2011 as slowing global growth and a grinding 22% increase in the Dollar pushed the GSCI Commodity Index down more than (70%) before recovering slightly in the past month (now only down (65%) over five years). All commodities have suffered over the period, but none as much as oil (which makes up the highest weight within GSCI) which fell (75%) from peak to trough. While gold "only" fell (30%), gold mining stocks fell just over (80%) and had been given up for dead before staging an extraordinary rally in 2016 (details below). We discussed last time how in Q4, commodities were battered again as GSCI plummeted (16.6%) and we observed that at least there was a small Dollar move to explain the losses (unlike in Q3), as DXY was up 2.5%. That said, we wrote that were somewhat puzzled by the magnitude of the collapse as, *"A smallish move in the Dollar (in theory) shouldn't have produced double digit losses in commodities, but continued fears of a hard landing in China (despite no real evidence, but lots of conjecture), a slowdown in developed markets and even more rapid deterioration in growth in emerging markets led to continued selling of commodities."* That type of exaggerated movement felt vaguely like capitulation and we began to think that a bottom in commodities was finally possible. We had written of this inkling in the Q3 letter that, *"There could be some continued Dollar strength so the commodity headwind would not subside quite yet, but all cycles turn and given the decimation across the commodity complex, some of the moves off the eventual bottom will create tremendous investment opportunities."*

As we penned the Q4 letter in January, it appeared that some meaningful changes were occurring across the commodity complex. For the first three weeks of January, the Dollar remained flat (despite all kinds of prognostications for epic strength in 2016), but Oil was in free fall, down (27%), taking the GSCI down (15%) with it and gold miners were down another (10%), but interestingly gold had suddenly caught a bid and was the one asset not falling (SPX was down (8%) at this point) and GLD was up 2%. As we prepared our 10 Potential Surprises for 2016 presentation, MCCM Surprise #9 spoke to the *"truism in commodity markets, the cure for low (high) prices is low (high) prices. It turns out capitalism works and high prices bring on new capacity that eventually collapses prices and then low prices lead to shuttering of capacity they eventually allows prices to move back up."* It took a couple more weeks, but February 11th was potentially the bottom. The Dollar (DXY) had begun to fall (on dovish comments from QEeen Janet) and was down (3%), stocks (SPX) hit their maximum loss at down (10.4%), Oil (WTI) hit the low at $26.21, down (29%), GSCI was still down (15%), but suddenly gold had gone on a tear and GLD was up 18% and the miners (GDX) were up a stunning 34%. Once again, a relatively small move in the Dollar should not have created those types of huge moves in commodities, but when everyone in the markets is short one particular asset, the short squeeze can be quite extraordinary and that is exactly what played out over the balance of Q1. Over the last seven weeks of the quarter, commodities kept surging, and while the Dollar finished down only (4.5%), oil surged back in to positive territory, up 3%, and the GSCI rallied almost back to flat, down (2%). Gold settled a bit and finished the quarter up a very solid 16%, but it was the miners that set the pace, surging 45% over the three months (it turns out that when companies come close to bankruptcy, but stay alive, their equity acts like an option and returns can be staggeringly good). But the fun didn't stop there, as April was another extraordinary month for commodities with oil surging 20%, GSCI jumping 12%, GLD rising 5% and GDX soaring an amazing 29% (to be up 88% for the CYTD) while SPX was flattish, up 0.4%, and DXY fell another (2%).

As wild and harrowing as the global equity roller coasters were in Q1, the most extreme ride goes to the Crudecoaster, as oil volatility was record setting with an astonishing 80% of trading days in the quarter seeing WTI move more than 5% intra-day (let that one sink in for a moment, the average percentage of days in a year with such moves is closer to the teens and previous peaks were around 35% in 1986, 2008 and 2009). From the year end price of $37, crude oil quickly shed (27%) over three weeks, bounced back 23% in just one week, collapsed (21%) in two short weeks and then caught the chain lift for six long weeks and rose 58% before falling (8%) in the last week to finish about back where it started at $38. We wrote last quarter that the year-end price was a white knuckle decline from the peak in 2014 saying, *"Going all the way back to the 2014 peak of $107.26, the damage is quite extreme; with WTI prices at $37 to end the year, the peak-to-trough return is an extraordinary (65.5%),"* but then we add the drop to the bottom on 2/11 at $26.21 that peak to trough fall extends to a breathtaking (76%) decline. All throughout 2015 there were pundits and self-proclaimed oil experts calling for a bottom to the oil decline starting at $60, then $50, then $40 and we wrote, *"We have said on many occasions that there were simply too many bottom callers for there to be a bottom... The problem with all these forecasts in our mind was that they collectively seemed to be missing (not sure why, as it seems pretty clear) that this is a Supply Shock, not a Demand Shock, and history tells us that prices tend to stay #Lower4Longer after the former and have more of a V-Bottom in the latter."* From our conversations with our best energy managers and other commodity experts we interact with on an ongoing basis, we developed a view that oil would show continued price weakness into early 2016 and begin to recover in the second half of the year. We memorialized that view in January in MCCM Surprise #4 (*Saudi is not Fracking Around*) saying, *"The resumption of Iran oil trading and short-term storage concerns push the market into steep Contango in Q1 and oil hits a multi-decade low in the 20s, but in the second half of the year the impact of cap-ex cuts and production declines push prices back toward $50."* Oil did indeed fall to the $20s in January and again in February, but on February 10th one of our favorite oil traders, Pierre Andurand went on CNBC and said he was no longer Bearish on oil and that prices would recover into the $50s by year end and into the $60s in 2017. Oil prices began to surge and the great squeeze was on (the use of CNBC to announce his view harkened back to the glory days of T. Boone Pickens who used the media to talk his book very effectively for many years). Pierre then went one better and raised his own bet a few weeks later in his March letter calling for $60 to $70 by the end of 2016, $85 in 2017 and closer to $100 in 2018. Prices surged again following the release of the letter and finished April up another 24% at $45.92. Pierre has forgotten more about oil trading than we will ever know, but we can't help but feel that prices have gotten a little ahead of fundamentals and there is some seasonality to this surge that resembles last year when prices went from $43 to $61 from March to May before collapsing in the second half down to $37. We don't expect a collapse this time, but we will stick with our original year-end target of $50 for now.

While oil and gold get all the media coverage, there are other commodities, and there have been some interesting developments in the commodity complex in Q1. Looking at Natural Gas, one of the biggest issues has been the impact of new technology (fracking) on the industry. We wrote last quarter that, *"Supply growth continues to completely overwhelm demand growth in Natural Gas as new technologies have revolutionized production in basins like the Marcellus and Utica and prices have been essentially in free fall since 2013. For the year, Natural Gas plunged (22.8%) and peak-to-trough losses are a staggering (62%)."* The pain continued into the first part of 2016 as the extremely warm winter (that we warned about last quarter would result from the massive El Niño) throttled demand and Natural Gas prices collapsed another (30%) through 3/3 (bringing peak to trough losses to (73%) since the height of the Polar Vortex in February 2014). A small blast of arctic air and some big snowfalls boosted prices from the low of $1.64 back to $1.96 to end the quarter "only" down (16.1%). Curiously, prices have crept up 11.2% during April to $2.18 (still below the 12/31 price of $2.34), and while storage has never been fuller, and production in the Marcellus and Utica is breaking all records, there seems to be some balance around the $2 level and the futures curve puts Natural Gas above $3 sometime later in the year. The Copper price has historically been one of the best early warning signs of an impending economic slowdown (nicknamed Dr. Copper). Looking at the extraordinary drop since 2011 from $464 to $213 at year-end, Dr. Copper would say that the economy was in the ICU, but that has not been the case and while growth has not been robust, there has not been a Recession. So there must be something else going on. We wrote about that something else last quarter and in MCCM Surprises #5 (*A Black Swan Alights in Europe*) where we discussed how some of the big global commodity trading firms were teetering on the edge of insolvency and there was some Bear Raiding going on in the copper markets. Copper prices were weak again during the first two weeks of 2016, falling another (9%) to trough at $194, but have staged a roller coaster-esque recovery of sorts in the past few months and clawed back to up 2.2% for Q1 and now up 7% CYTD through the end of April at $228. The trading company stocks have soared off the bottom, with some up more than 100%, but there is still a problem that copper prices are nearly 2X the cost of production and that means that Dr. Copper may have to take a little more nasty medicine in the coming quarters.

Precious metals were poor performers all throughout 2015 and Q4 actually felt somewhat cathartic. As 2016 began and the equity markets were caught early in the jaws of the China Bear, the discussion on metals turned toward their currency role (away from the commodity character) and Q1 was more hospitable for the metals as Gold surged 16.2%, Silver 11.5% and Platinum rose 9.4%. Only Palladium stayed mired in the commodity malaise and was essentially flat for the quarter. April saw an acceleration of some of the bullish commentary on the commodity markets and gold jumped another 5%, silver exploded up 15.6% (to now be up a very surprising 29% CYTD). Historically when gold miners and silver are outperforming the gold metal that has been confirmation of a bullish trend. Finally, Agricultural commodities have been so extremely volatile due to weather, uncertainty about the Dollar and global growth concerns that it has been best to simply ignore the sector altogether from an investment perspective. Wheat, Soybeans and Corn plunged (24.1%), (14.8%) and (16.4%), respectively, in 2015 and Q1 was not much better with varied returns of down (0.5%), up 4.7% and down (4%), respectively. There has been some increasing discussion of Soybeans lately and beans were up nicely, 11.4%, in April, but the volatility has simply been too extreme. We reiterate what we wrote two quarters ago, *"The grains might be considered "untradeable" and we have spent very little time in this area as the wild gyrations related to changing weather forecasts and production surprises have not lent themselves to solid fundamental analysis. Perhaps these markets will revert back to a more consistent trend following pattern, but until then, we will leave them to those with higher levels of short-term trading acumen,"* and will remain consumers of Ags in restaurants, but not in our investment portfolios.

Turning to Hedge Funds, we wrote last time about the challenging media reputation of this segment of the investment industry saying, *"Throughout my career I have always been amazed at the level of negativity in the media toward hedge funds and hedge fund managers. I could never reconcile why, given the substantial outperformance of hedged strategies over long only over the long-term, there was always a negative slant in the media."* We went on to discuss how there was a lot of piling on as returns in 2015 were modest across the board and in some cases there were managers who did have very poor performance. We also made an important point that, *"It wasn't the hedge"D" funds that struggled in 2015, but rather the long-only, Activist managers (which arguably shouldn't be called hedge funds, despite charging incentive fees) that suffered from over-concentration in areas like healthcare."* Unfortunately, hedge fund managers gave the media a little more grist for the mill in Q1 as collectively they produced negative returns and in the long/short equity segment there were some truly awful (actually not using this term lightly) performances. It is rare to be able to use the word collectively with hedge funds since there are so many disparate strategies and I normally rail against the terminology, saying that "hedge fund" is as useless a term as "mutual fund" since it is simply a legal structure. You rarely hear someone say that Mutual Funds performed poorly/well (because there are hundreds of different MF styles), yet people talk about Hedge Funds as if they were some monolithic behemoth when in reality there are dozens of strategies and sub-strategies that perform quite differently in different environments. Just like one would never compare performance of a bond mutual fund with an equity mutual fund or a commodity mutual fund, one should not compare performance of a long/short equity hedge fund with a distressed debt hedge fund with a macro hedge fund. All that said, all the various hedge fund strategies produced disappointing performance in Q1 (some more disappointing than others) and the highest profile managers (read: those who the media tends to write about most often) did not do themselves (or the industry) any favors in the first few months of 2016.

Looking more closely at the various categories of hedge funds, the HFRX Global Hedge Index was down (1.9%) in Q1, which failed to meet its expectations of providing protection during the roller coaster quarter. This underperformance is even more pronounced when compared to the long only MSCI ACWI Index's claw back to flat, up 0.2%, for the period. Narrowing the scope of comparison solely to the U.S., the results were even worse. The HFRX Equity Hedge Index fell (2.9%), which looks quite bad relative to the S&P 500 clawing back to a gain of 1.4%. There is some solace in the fact that the HFRX Market Directional Index was down (6.5%), as this index strips out some of the lower net strategies and gives a better reflection of what happened in the more Jones Model long-biased funds. The real issue, however, surfaces when looking at the trailing twelve months where the HFRX Global and U.S. Indices were down (7.4%) and (7.2%), respectively, while the ACWI was down only (4.3%) and the S&P 500 was actually up 1.8% (again, the HFRX Market Directional Index was down (16.8%) for the past year which helps explain some of the tough performance of the long-biased segment). Another problem is that in Q1 while the point to point (12/31 to 3/31) return comparison looks bad, it was the comparison at the trough in February that really looks bad. Markets were down nearly (10%) and many long/short managers were down as much (or, in some cases, more) than the market. So what is going on? Have long/short equity hedge fund managers lost their edge? The short answer is no. The long answer is also no; we have seen this movie a couple of times before, and we know how it ends (with the long/short equity managers coming out on top and equity markets down a lot). The past few months have witnessed a couple of phenomena that we have not seen very often in equity markets historically (in 2000 and 2008 most recently). A couple of other index returns can help shed some light on the issue, the R2000 (small cap) and RTop200Growth indices returned (1.5%) and 0.8% for Q1 and (9.8%) and 5.7% for the past year, respectively. So what do these indices have to do with hedge funds? Long/short equity managers endeavor to go long good stocks (buy good companies, or O.K. companies at attractive prices) and go short bad stocks (sell bad companies, or good companies at unattractive prices) to produce alpha. On occasion (around market peaks) the valuations of good companies gets so poor that hedge funds short them, and, as a general rule, there is a slight small/mid-cap bias across the long/short space (it is easier to gain an edge in smaller companies with less analyst coverage). When equity markets become very narrow (only a few sectors or stocks going up) and valuations rise to unattractive levels, long/short equity managers can find themselves wrong twice. Being long smaller companies and short the mega-caps has been a bad trade for the past year, and was particularly painful in the last couple of quarters.

We wrote last summer that, *"We will continue to make the case for utilizing hedged strategies rather than long-only strategies in the equity markets as we have been for that past year. While we were slightly early, we expect to see the relative performance advantage of hedge funds continue to expand as 2015 winds to a close and the tougher period of 2016 to 2017 begins (in our 2000 to 2002 déjà vu scenario)."* With the benefit of hindsight, we can see that we were wrong (one quarter is "early," three quarters is wrong) but we understand the outcome a little better after seeing some recent data from one of the prime brokers. They showed that over the period from 7/1/2015 to 3/31/2016 the top 50 most widely held equities in long/short hedge funds fell an astonishing (31%) versus a decline of only (2.8%) for the S&P 500. Some might say that this is proof that Hedge Funds are finished, and that clearly investors should rush into Index Funds. We will take the other side. We have seen this phenomenon before (and heard the same dire predictions that hedge funds would go away) back in early 2000 and early 2008. We do not believe that the group of managers that investors clamor to gain access to and can charge high fees (compensation is usually linked to quality and performance in every industry) has suddenly become universally stupid. So then what is going on? We think the answer lies in what we wrote in Q4 2015, *"While we were indeed early (as the relative performance was not as strong as expected), we continue to make the case (now even more vehemently) that hedge"D" equity strategies will significantly outperform long-only equities in the quarters and years ahead as #2000.2.0 continues to play out in the economy and markets."* Again with the benefit of hindsight, we were wrong on the timing of the #2000.2.0, and after looking at a great deal of data, we are changing our view to align more with the timing of the economic, Presidential, performance and capital flow cycles. What we missed in the analysis that drew a parallel between 2015 and 2000 (rather than 2016) was that 2016 is the election year (and a rare 8th year of the seated President, which amplifies the Presidential Cycle). The economy though weak, is unlikely to fall into Recession until 2017 (right on cue in the first year of the Presidential Cycle). The rapid decline in oil prices likely extended the expansion, and there was no underperformance of long/short strategies relative to the Index (like Q1 2000) until now. Looking back at the headlines in 2000 to the claims that hedge funds were obsolete, great firms like Tiger Management were no longer relevant (the spin outs from that firm dominate the investment industry, in case anyone is keeping score at home), and how anyone who didn't put all their money in Index Funds was foolish, it really is "Déjà vu all over again" (RIP Yogi). "Forewarned is forearmed," and "Precaution avoids perils," are likely to be some important words to live by in coming quarters.

As was the case in 2015, the biggest pain in hedge fund land in Q1 was felt by the Activist managers as many of the celebrity funds fell another (10%) to (20%) to bring trailing year losses to (40%+). The HFRX Event Driven Index (which doesn't include the brand names since the largest hedge funds don't report to these indices) fell another (1.2%) for Q1, and underperformed equities again over the past year, falling (9.4%) as the travails of the celebrity funds crushed the names most highly trafficked in by the event driven managers. MCCM has historically avoided Activist managers (mostly because they don't hedge), and as we discussed last time that, *"While we believe that there are a few groups (like ValueAct) that have generated outstanding returns over time, we have not seen the level of Alpha we require to warrant paying hedge fund fees."* The inherent Beta (and associated volatility) of Activist strategies has risen over time, perhaps as more firms have followed the strategy or as more investors have tried to follow their ideas. As an interesting, though possibly pointed, side note from a recent trip to London, one manager (who was actually up 13% in Q1) explained that a meaningful part of their short strategy is to be short the Activist's longs.

One area that didn't struggle as much in Q1 as in the past year was Credit. The HFRX Distressed Index fell just (1.5%) as credit spreads began to fall from the highest levels seen since 2009 (peaked on February 11th), and fears of an imminent wave of bankruptcies and defaults subsided (for now…). For the trailing year, the Distressed Index was still down (12.9%), and the index number masks the pain felt in certain segments of the market where managers tried to catch the falling knife of energy credit (read: lost a few fingers). While there was a relief rally around the recovery in oil prices (and investors poured money back in to HY bonds at a record pace), we still anticipate more tough times ahead for the credit markets over the next few years. Given the very high level of energy related debt (equivalent to level of Telecom debt in 2000) in the indices, we wrote last time that, *"While there was a very brief rally in these credits in Q2, energy debt crashed in Q3 and crashed even harder in Q4 as the reality began to set in for investors that there was simply too much debt raised for marginally economic drilling projects, which have now been rendered non-economic by Saudi's decision to raise production, lower prices and take back market share."* We also wrote last time that we believed wholeheartedly that there would be great opportunities in this space. *"'The distressed debt sector will provide some compelling investment opportunities, but not until later in 2016 and 2017,' so it will be best to wait for these knives to fall completely to the floor before attempting to buy."* We also mentioned how one firm predicted that the lowest quality bonds would need yields closer to 25% in order to clear the $1 trillion market (materially higher than the then current yield of 15%). Yields in the CCC space did surge to 21% in early February; however, it appears that investors couldn't wait and plunged back in to these bonds driving yields back down to 16%. We are still wary that everything is fixed in the oil patch and we are reminded of the last gasp rally in 2001 within the Telecom sector before companies like WorldCom and Qwest defaulted (and disappeared, taking huge piles of investors' money with them). There were some tremendous opportunities to make big returns buying the good assets from the bad balance sheets in 2002.We would expect those opportunities to come again, but not until 2017 or 2018.

As in Q4, the best (read: least bad) hedge fund strategies in Q1 were the Macro and Absolute Return strategies that managed to come close to break-even (or even make a little money in merger arbitrage) amidst a sea of red numbers in the league tables. The HFRX Absolute Return Index fell a fractional (0.6%) for the quarter, and has been essentially unchanged over the past year, up 0.6%. The lone standout in the sector was the HFRX Merger Arbitrage Index which rose 1.6%, and is up a very solid 7.4% over the past year. Absolute Return strategies (Merger Arbitrage, Market Neutral) continue to fight the brisk headwind of Zero Interest Rate Policy (and now the threat of Negative rates, or NIRP), and the generation of Alpha (or simply avoiding negative returns) in such an inhospitable environment is a positive outcome (and better than the majority of other strategies). We wrote last time that, *"Making a little bit of money each month and avoiding big losses has been the secret to the success of the Absolute Return strategies over the past year. Importantly, should the #2000.2.0 scenario play out in the coming years, we should recall that equity investors lost (40%) over the 2000 to 2002* *period while Absolute Return investors made nearly 20%."* If it turns out that we are right and this period has just begun, these relative returns could be quite compelling. As we explained last time, it is just math. An investor finishes with twice as much wealth at the end of the period ($120 instead of $60 for every $100 invested). In Macro land this quarter, the HFRX Macro/CTA Index was flat at 0.1%, but also struggled against ZIRP over the past year, down (5.1%). Interestingly, if you only read the headlines, you might think Macro was down big along with the Activist funds. There is a rising cacophony that these are unacceptable returns given the level of fees paid but we will continue to make the case that the greatest benefit of the high fees comes from the returns during the truly difficult times, which may be closer than we think. Most importantly, the extremely low correlation of Absolute Return and Macro returns to traditional assets (stocks and bonds) make them an extremely attractive component of a long-term wealth maximization portfolio (which never makes the headlines). Macro funds, in particular, have proven to be a great diversifier to portfolios by providing very strong returns during difficult markets (most notably 2002 and 2008), which may be highly prized in the coming years.

We have written for many quarters that, *"We continue to believe that one of the best portfolio moves today is to reduce traditional fixed income exposure (except for long bonds which people should hold as a Deflation hedge) and replace that exposure with hedge funds."* Historically, the primary purpose of fixed income in a diversified portfolio has been to counterbalance the volatility of equities, which are necessary as the core of the portfolio in order to generate returns in excess of inflation. Given current conditions, traditional bonds are unlikely to deliver adequate returns to warrant their inclusion in portfolios, despite their risk reduction benefits (the opportunity cost is too high). We believe that a superior strategy is to utilize a diversified basket of hedge fund strategies to provide similar diversification benefits with significantly higher expected returns. In a period of high valuations, uncertainty, and high volatility, Alpha will outperform Beta, and we expect that environment to be the base case in the years ahead. The key to success is allocating to managers with consistent security selection Alpha, as they will have the highest likelihood of generating superior returns in a challenging investment environment. We noted last time that, *"Perhaps a greater challenge is managing through periods when the worst companies will actually outperform the best companies (when Central Bank liquidity artificially inflates prices like from 1995-2000 and again from 2009-2015) as during these periods, investing in hedge fund appears to be a really bad idea. In fact, toward the end of those periods, it seems like an awful idea."* We did not realize how prophetic those words might be as hedge funds strategies tried their best to make themselves appear to be an awful idea in Q1. We have said in the past (and will say again in the future) that in investing, it is precisely when you have the greatest urge to hit the sell button, that it is actually the most critical to increase exposure to the hedged strategies. As we argued in the *Experts Only* letter, *"We can make a compelling case that long/short investing is a superior strategy to manage equities in all environments, but understanding the reticence of some to have hedge funds as their core investments, investors should increase exposure to hedge"D" strategies when valuations are high and growth prospects are diminishing (like they are today)."* As Shakespeare reminded us above, in these situations it is always ***"Better three hours too soon than a minute too late."***

Just like Q4 last year, Q1 was a tale of two periods, only in the reverse of 2015. In describing the second half of Q4 in the last letter, we discussed how the aversion toward risk assets emerged, *"after the Fed actually did raise rates in December,"* when *"Investors became increasingly nervous as the quarter progressed and December returns gave a little glimpse over the edge of the ski slope that lay ahead in the New Year."* That ski slope did materialize in January and markets went "straight down" for the first six weeks (as a manager friend in San Francisco predicted), but the roller coaster analogy turned out to be better (for third quarter in a row), and we ended up right back where we started. We have been enduring an awful lot of volatility, and have nothing to show for it. I tweeted out a pair of charts last week that showed the returns of the S&P 500 over the period from 6/30/99 to 3/31/00 and 6/30/15 to 3/31/16, and they were amazingly similar. Lots of volatility and essentially no return for almost a year is not an ideal outcome for investors, but, if history rhymes, what could come next might be even less palatable. The performance of the Morgan Creek funds was mixed in Q1. The issues impacting hedge funds discussed above hit the Long/Short Equity Hybrid Fund very hard during the period and hedging and Frontier Market exposure held back returns during the March rally in the Developing Markets Hybrid Fund (see details for both hybrid vehicles in the following individual fund sections). Our Liquid Alternatives Funds were split, with the mutual fund trailing and the ETF leading (due to a higher tactical allocation to cash). The Morgan Creek Partners family of Private Investment Funds continued to perform well as a result of a number of meaningful liquidity events in the portfolios in recent months. In conclusion, as we continue to believe that the 2016 to 2018 investment environment will be very similar to the 2000 to 2002 environment, the key will be to navigate these challenging times by embracing a differentiated investment model that seek to provide higher returns and considerably lower volatility as the party really gets going in the months and quarters ahead.

Market Outlook

In last quarter's letter the theme was *Experts Only* and we discussed how skiing and investing had some similar characteristics and how the current investment environment might require expert skills in the New Year. We wrote, *"One of my best manager friends had texted me on New Year's Eve that he was afraid that the markets could go "straight down" in January. His insight turned out to be quite prescient, as it proved to be one of the most difficult Januaries in market history (the first five days were the worst ever to begin a year)."* While markets were able to take the ski lift back up in the second half of the quarter (details above in the roller coaster segment), we stand on the similar peak today (and the same peak as November 2014 for that matter) to the one we stood on in December. In fact, a chart of the S&P 500 over the past couple of years looks eerily like a series of mountaintops (some technicians have said it looks like a big single top). We compared skiing to investing saying, *"Both skiing and investing are activities that can be enjoyed for a lifetime and the more you participate in the activity, the better you get. In both disciplines the more experience you have the more challenging situations you can master."* We also quoted Edward Whymper (the English mountaineer) who made an observation about mountains, ***"The thing to be wished for, is not that the mountains should become easier, but that men should become wiser and stronger."*** Human nature drives us to want to conquer the most challenging terrain, but success requires the kind of wisdom that comes from accumulated experience (surviving and learning from your mistakes). With wisdom comes the self-knowledge to know when to accept the challenge and when to go back to the lodge until the conditions improve. We believe we are at one of those critical junctures in time when the wise investor will choose the latter.

One of the themes we have talked about for a while is that in the markets, gravity always takes over in the end. Valuations can reach high levels for a period of time, but they always fall back to the average. Corporate profit margins and earnings growth rates can stay high for a while, but they eventually revert to the mean (capitalism works). In the *Experts Only* letter we described how this construct applied to skiing by saying, *"The very best alpinists can manage slope angles in the low to mid 60 degrees, but on anything steeper, it becomes very difficult to maintain the ski's contact with the snow. In fact, snow's "angle of repose," the maximum tilt at which snow can stick* *to a slope is 75 degrees."* We also wrote about how you should always expect the best, but plan for the worst, because in extreme terrain the margin for error is small, but the consequences can be big. One of the best ways to ski/invest is to pay attention to the trail markers (we can't control the trail ratings, but we can observe them), pay heed to additional warning signs (particularly Experts Only signs pointing to extreme terrain), and, *"follow a strategy that will keep us compounding our wealth, rather than nursing a compound fracture."* As Greg Child, author of *The Other Side of Luck* wrote, ***"The mountains are beautiful but they are not worth dying for."*** Last November we created a list of the ***Not So Nifty Fifty*** reasons why it was time to get hedged in the U.S. and we have updated the trail markers below to reflect current data. The bottom line is that things are still not so nifty and it remains time to be hedged.

1. Welcome to the *New Abnormal.* We coined this phrase a few years ago as we thought there was nothing normal about the equity market environment since the extremes of 2000. From 1983 to 1999 the MSCI World Index almost never went down (2/17 negative years), compounded at an impressive 14.8% and the intra-year drawdowns were a not so scary (10.5%). From 2000 to 2015 the World Index has gone down often (one third of the years) and has only compounded at 3.5% while experiencing average drawdowns of a gut wrenching (17.3%).
2. Post-Crisis Deleveragings are measured in decades. There have been four great unwinds, the U.S. in 1873, the U.S. in 1929, Japan in 1989, and the U.S. since the 2008 trough, and it takes 14 years on average to reach trough long-term interest rates which tend to settle between 1.5% to 2%. We are currently in year 9, so 2021 looks like the likely trough.
3. Global Trade has not grown since 2008 and the pace of its decline has recently accelerated. Low levels of global exports have historically been an early warning signal of global Recession.
4. Industrial Production always turns down ahead of Recessions and has now declined for seven consecutive months (and fourteen of the last sixteen). We have never had six consecutive monthly declines without having a Recession follow within a year.
5. Even if the next Recession were a shallow one like 2001 (two slightly negative quarters that weren't even consecutive) the market impact would likely be significant given the level of current valuations and the average correction during a Recession is (38%).
6. ISM ticked down in April to 50.8 and now is slightly above the contractionary sub-50 zone. Historically, an ISM of 50 indicates a 65% chance of a Recession within the next year.
7. Leading Economic Indicators ticked up slightly, but still point to the ISM dropping below 50.
8. Q1 GDP growth (first estimate) came in at a very disappointing 0.5% (likely will be revised even lower) which points to an ISM reading well below 50.
9. Regional Fed Surveys have been consistently bad and are now all pointing to a lower ISM.
10. S&P EPS and Cash Flow growth rates remain solidly negative, which points to an ISM below 50.
11. The Durable Goods Orders growth rate has collapsed back below zero (2.5%) pointing to an ISM in the 40s.
12. When S&P 500 EPS Forward Estimates peak (as they did in Q3 last year), and continue to decline (as they have in Q4 and Q1), there historically has been 100% probability of a Recession within the following year.
13. Consumer Confidence has rolled over to levels normally found in Recessions.
14. Retail Sales growth is trending down at an accelerating pace, heading toward Recessionary levels.
15. There is barely a whiff of Inflation anywhere with both Headline CPI and PCE (Personal Consumption Expenditures) currently well below the Fed target of 2% (Core Inflation is at 2.2%, but turned down again in April).
16. PPI is at levels (1.9%) only seen in the depths of

the Global Financial Crisis in 2008.

17. U.S. GDP continues to be weak with Q2 currently trending at 1.7% (and falling) according to the Atlanta Fed GDPNow indicator (versus a 2.35% consensus).
18. Extremely high Inventory levels could become problematic and have historically been a Recession trigger as the inventory cycle turns from destocking to restocking.
19. Forward Inflation Expectations (5 yr./5 yr.) have recovered slightly to 1.7%, but remain at levels where past QE programs were initiated (in sharp contrast to Fed jawboning about raising rates).
20. Long Bond rates have fallen to 2.6%, signaling that Deflation is a much larger risk than Inflation.
21. History actually indicates that the Fed should raise Fed Funds to 3% (historically, FF equals nominal GDP growth rate). Fed must believe the economy is much weaker than it was historically to keep rates at a near zero level.
22. Contrary to popular belief, the Fed has not eradicated the Business Cycle and there are many indicators lining up to say we closer to the end of the current cycle than the beginning.
23. Fed tried to leave ZIRP (Zero Interest Rate Policy) too early in 1937 and we had a bad outcome (respectfully called the Great Depression). There is actually a case to be made that the Fed has lost control and there is no way out, just like in the 1930s.
24. When the Fed is not expanding the Balance Sheet, U.S. equities have struggled (actually made no return) over the past five years. With no more QE, where will equity returns come from?
25. It is looking increasingly likely that faith in the global Central Banks is waning. European and Japanese stocks have fallen dramatically since the last rounds of QE/QQE by the ECB & BOJ.
26. U.S. equities remain at extreme levels of valuation, 83% above their long-term regression.
27. U.S. equity TTM P/E and Adjusted P/E ratios are the third highest they have ever been.
28. The Buffett Indicator of the ratio of Market Cap/GDP is second highest ever, only worse in 2000.
29. The Q Ratio (valuation vs. replacement cost of corporate assets) is near record levels.
30. Margin Debt (the rocket fuel for the rally since 2009) has begun to roll over and when it turns down it tends to decline very rapidly, leading stocks lower.
31. Inflation Expectations levels have historically been highly correlated with forward P/E ratios and the collapse in inflation expectations argues for much lower equity multiples (lower by 35%).
32. GMO Forecasts poor returns for traditional assets over the next seven years including an approximately 2% nominal compound annual return for U.S. equities.
33. Another longer-term equity model used by a number of asset managers (created by Butler-Philbrick) also predicts a slightly negative real return for U.S. equities over the next decade.
34. The December 2014 Barron's cover could be an example of Front Page Syndrome. When comparing the 2009 to 2014 move in equities to the move from 1995 to 2000, the current rally should have ended last spring (April 2015).
35. The Strategas Equity Trend Model turned negative in Q3 2015, just like it did in 2000 and 2008.
36. Market Crises are highly correlated with Dollar surges like the one we have just experienced in 2015. The question is whether we're more likely to see an environment like 1998, 2000 or 2008?
37. Equity market cycle highs usually occur in Q4 of the 4th year of the Presidential Cycle (this year) and cycle lows usually occur in Q1 of the 1st year (Q1 2017) or the Q2 of the 2nd year (Q2 2018) which aligns nicely with the #2000.2.0 playbook of a Recession and market trough in 2017 matching up nicely with the 2001 to 2002 period.
38. Small-cap weakness (lagged large-caps badly in Q1) has historically been a sign of deteriorating market fundamentals.
39. There is huge dispersion in valuation and margins across equity market sectors, which has historically been a target rich environment for long/short investing.

40. The current equity market advance is becoming increasingly narrow (without FANG: FB, AMZN, NFLX and GOOGL, the S&P 500 was down (5%) in 2015).
41. Only the largest Technology and Consumer companies are rising within their sectors.
42. The trend in the Consumer sector has deteriorated dramatically in the past year and only two sub-segments still have positive momentum.
43. Energy sector fundamentals remain weak and there is real risk of rising bankruptcies in the sector (despite higher oil prices) as overleveraged companies are shut off from additional capital.
44. The Healthcare sector remains under attack and is an example of how fragile equity markets are in the current environment.
45. Biotech, in particular, has experienced a meaningful down draft as valuation questions surfaced.
46. The Four Horsemen of the #Growthpocalypse (copper, Korea, oil and interest rates) are all pointing to slower growth and potentially lower stock prices. Dr. Copper, in particular, remains sick, recently giving back all the Q1 gains, and falling copper prices have been a leading indicator of slowing growth.
47. The KOSPI Index rallied along with other EM in the second half of Q1, but has declined back below the 2000 level. KOSPI has been a good leading indicator of slowing growth in the U.S. (and lower equity prices) given high tech components weighting.
48. The rapid recovery in oil prices over the past few months has the potential to reverse some of the stimulus provided to consumers as gasoline prices rise.
49. The 10-year Treasury rate has been stubbornly low at 1.76% (in stark contrast to predictions they would rise above 3%), likely a sign of deflation risk and slowing growth.
50. Unemployment numbers have begun to plateau and are at levels which have been associated with ends of economic cycles in the past.

We wrote that our overall Market Outlook for the beginning of 2016 was, *"for a global investing terrain that is rated Double Black Diamond EX (Experts Only), where the primary message is it is time to be hedged. Just like in other challenging times there are compelling opportunities all over the globe, the rising risks to the global economy call for a shift toward a portfolio dominated by strategies (and positions) that favor Alpha over Beta, Manager Skill over Passive Indexing & ETFs and those that capture illiquidity premiums rather than rely on rising public market valuations."* The volatile start to the new year confirmed that the environment is one that favors Alpha over Beta and the global equity markets have not made much progress in over a year. Valuations are stretched, growth is slowing and liquidity has evaporated with the over regulation of the banks and the beginnings of a new NPL (nonperforming loan) cycle beginning to appear. In times like these our advice for skiers/investors was, *"For most investors, like most skiers who encounter the Experts Only trail marker, the right decision today is to head back to the lodge, move to the safety of hedged equity strategies and raise cash to have dry powder to deploy when the environment is more hospitable. There will be another snowfall (correction) that fills in the deep ruts in the mogul fields of the capital markets, but like predicting the weather, knowing precisely when is challenging. The best thing to do when confronted with an Experts Only environment is to leave the investing to the experts, those hedge funds and private investment firms who make schussing down a 60 degree, mogul filled, chute look like they are carving turns on a corduroy bunny hill."* As we discussed in more detail above, Q1 was not quite so smooth for hedge fund managers as challenges on both the long and the short side resulted in one of the worst relative performances in many years. Even great skiers fall on occasion, but that doesn't make them less good, it just means they misread the terrain, didn't see a hazard on the slope or simply made a bad turn, caught an edge and ate some snow. The really great ones get up, dust themselves off and head back down the hill with great form and great results and that is what we expect to see in the quarters and years ahead as we get through the next storm that is brewing on the horizon.

At this point in past letters we have done an Around the World Tour to discuss the most compelling investment opportunities. Last quarter, however, we had the luxury of doing our 10 Potential Surprises for 2016 ATWWY Webinar, and those Surprises offered an outline for our commentary on the markets. We thought we would follow that same outline again this quarter and weave in a little Prince and Shakespeare just for fun. We have given each Surprise a Prince song title and have sprinkled in a few quotes from the Bard along with some thoughts on the major market opportunities we see today.

2016 10 Surprises

Our January ATWWY Webinar was entitled "Channeling Byron: 10 Potential Surprises for 2016" (with a nod to Byron Wien, the former Morgan Stanley Strategist who originated the annual 10 Surprises idea). When talking about Surprises it is important to clarify that Surprises are intentionally non-consensus ideas and have some reasonable probability of not occurring (they are not necessarily predictions). The unlikely nature of a true Surprise fits in perfectly with the famous Soros quote about how meaningful returns are made by, "discounting the expected and betting on the unexpected." Michael Steinhardt was famous for saying that, "we made all our big returns from variant perceptions that turned out to be right." To his point, the definition of a Surprise is a variant perception (an idea that is materially different from the consensus) that we believe has a better than 50% chance of occurring in the current year. The key point here is that a variant perception must be *materially* different than consensus to be valuable. One other important point to be mindful of is a year is a long time, things can change (sometimes dramatically) and we need to remember the wisdom of John Maynard Keynes who famously quipped, "When the facts change, I change my mind. What do you do, sir?" We will remain vigilant during the year to track the progress of each of these Surprises and look for opportunities to capitalize on them in the portfolios, but we will also be ready to change our minds (and our positioning), should the facts change.

Surprise #1: There Goes the Boom…
(*I Would Die 4 U)*
Despite massive Central Bank stimulus programs around the world, economic growth continues to surprise to the downside as the rising costs of aging populations weighs on the Developed Markets. One (or more) of the U.S., Europe and Japan slip into Recession and global interest rates continue to plumb new lows.

Perhaps a bit extreme in the song title choice, but we do think that the global economic cycle is on its last legs and will come to an end in developed markets in relatively short order. We actually already have seen Japan slip back into a technical recession as Q1 GDP fell back to negative (0.3%) erasing the lackluster 0.3% rise in Q4 after a down (0.4%) in Q3 2015. With PMI at 48.2, Japan looks very much like the 2001 U.S. model short and shallow recession (but a recession nonetheless). Europe has perhaps (key word) turned the corner and while there is no reason to celebrate a 0.6% increase in Q1, it is better than the 0.3% increase each of the last two quarters and PMI has bumped up to 51.7, which is expansionary (for now). The caveat is that these numbers are all backward looking and with the Euro strengthening this quarter, the momentum could fade. In the U.S., Q1 GDP was very weak, falling all the way to 0.5% from 1.4% in Q4 and 2% in Q3 (that looks like a bad trend to me). PMI did pull back above 50 (barely) to 50.8 after having a string of prints in contraction territory, but industrial production has been dreadful, so I am not sure we are out of the woods yet. While I was fairly confident of the chances for a U.S. recession in 2016 at the end of last year, I think the tailwind of low oil prices and the sudden reversal of the Dollar after the #ShangahiAccord may have pushed it out to 2017. That timing actually matched up better with the

Presidential Cycle anyway as most recessions start in the first year of a president's term. Shakespeare has a famous line that applies to economic cycles, ***"Out, out, brief candle! Life's but a walking shadow, a poor player that struts and frets his hour upon the stage and then is heard no more: it is a tale told by an idiot, full of sound and fury, signifying nothing."*** *(Macbeth)* Macbeth soliloquizes about the finite nature of human life and economic expansions are the same. They all end. Some are longer than others, but finite all the same.

The second half of the Surprise is going extremely well and long government bonds have been one of the best asset classes in 2016, again defying all the doomsayers who keep trying (in true Shakespearean tragedy fashion) to catch the falling knife and call the bottom in interest rates. The forces of deflation continue to be too great and JGB yields fell from 0.3 in Q3 of 2015 to negative (0.1) in Q1. European bonds fell from 0.1% to an even bigger negative (0.3%) and even the mighty U.S. ten-year fell from 2% to 1.8%. The gap between U.S. bonds and other global bonds simply seems too high, so one of them needs to give. It will be tough for JGBs to rise given the Negative Interest Rate Policy (NIRP) stance of Kuroda-san and QE expansion by the ECB makes it tough to see how bond prices fall (yields rise). That leaves a path lower for U.S. rates that will likely continue to confound the skeptics and make the bears who are short less rich as they continue to mess with the widow maker trade. Given the grisly nature of Shakespearean tragedies, that name fits exceeding well in this letter.

Surprise #2: Two Wrongs Won't Make it Right. ***(When Doves Cry)***
After trying to flex their muscles by raising rates in December, the Fed realizes the (policy) error of their ways, acknowledges that they missed the window to raise rates in 2013 and puts further increases to the Fed Funds rate on hold for 2016. In a total about face, discussions of QE IV begin in the 2H of the year as economic growth continues to disappoint.

Ms. Yellen, or perhaps my favorite nickname, QEeen Janet, more appropriately in a letter full of Shakespearean kings, is a full on dove and her dedication to QE and all things stimulus related has been nothing short of epic. Like a Shakespearean tragedy, her house has been under siege by the hawks and she has fought valiantly to keep the pedal to the metal on holding rates down. Prince's most recognized song title is so appropriate for the conundrum QEeen Janet faces and she could go into a full-on Hamlet ***"to be, or not to be"*** soliloquy on what to do about the Fed Funds rate, but this letter is too long already, so suffice it to say that if the doves cry uncle and give in to the hawks, we could see some serious crocodile tears around the global capital markets. The line from *As You Like It,* ***"Do you not know I am a woman? When I think, I must speak."*** is so perfect for the next few months as QEeen Janet will do a lot of jawboning to try and test the waters on whether she can actually act to raise rates despite a slowing global economy, huge Chinese RMB concerns and a general feeling that they missed their window in 2013 and any move would be interpreted as a policy error (that could also be what long rates are telling us as yield curve flattens). Just a hint of a rate rise for the June meeting has been enough to push the Dollar back into strengthening mode, knock half the gains off of the EM rally, whack the industrial commodities (exacerbated by the Chinese slowing down commodity futures speculation) and give the China bears a shot of adrenaline to buy more puts on the Yuan. There is another G7 meeting coming up and we think the woman who really runs the world (and thinks a lot better than just about anyone), Christine Lagarde, will straighten everything out (just like she did in February).

Surprise #3: Save Us Kuroda-san. You're Our Only Hope. ***(Delirious)***
BOJ Governor Kuroda surprises everyone at the end of the Japan Fiscal Year and pulls out another bazooka to weaken the Yen and stimulate the economy and markets. The Yen falls dramatically, with USDJPY hitting 135. Corporate profits surge to new record

highs and Japanese equities rally hard, finishing the year at 21,000.

Many of the readers of this letter probably saw the photo of Kuroda-san at the last BOJ meeting leaning back, looking up and laughing hysterically and probably had the same thought as I did, "Maybe he has really lost it." Delirious was the first word that came to mind on January 29th when Kuroda-san shocked the world by deciding to not add to QQE, but rather to embrace a NIRP after explicitly saying that he would not just weeks earlier. At this point, the other side of this Surprise has played out and it will be very tough for Japanese equities to recover much. Nikkei 21,000 is likely out of the question because of the reflexive nature of how important foreign investors are to the Japanese market and they have voted with their feet and repatriated their money so as not to get whacked by the Yen. The essence of this Surprise was that Kuroda-san would surprise everyone (like he did a couple of Halloweens ago) and pull out his QQE Bazooka, shoot another hole in the S.S. Yen and continue to boost corporate profits at Japan Inc. What we didn't anticipate was that he would turn the bazooka the wrong way and shoot himself (and bullish Japan investors like us) in the face.

Shakespeare has a line for this as well, ***"The course of true love never did run smooth."*** *(A Midsummer Night's Dream),* and our love affair (and profits machine) with Japanese stocks that began in November of 2012 has clearly hit a rough patch. After the delirium began, we cut Japan exposure by half and have cut the exposure to banks and exporters by more as they have been hit the worst by the Yen move from 122 to 110 (actually got as low as 105). Interestingly, the Nikkei has fallen from 19,033 to begin the year to a low of 14,952 in mid-February (down (21%) from peak), but has fought back to 16,500, only about 1,000 points, (6%), below where it began when Kuroda-san announced the NIRP. One thing to note is that the Nikkei has made a series of higher lows over the past few months and there are some signs of life in a few of the stocks that we follow closely. Japanese equities are still cheap relative to the U.S. and Europe, but EPS have turned down ever so slightly with the Yen move and we are watching that development for signs of acceleration. The value investor bias in us says to buy when everyone else is selling, but if this plan turns out to be more madness than method, and GDP and TOPIX profits continue to wane, then there could be continued downside. The other thing to watch carefully is that in the past decade, the Nikkei leads the S&P 500 in downturns by a few months, so this could actually turn out to be another warning sign to add to our Not So Nifty Fifty list of indicators telling us to reduce global equity exposure and get hedged. Finally, there are a few areas within Japan that will benefit from a stronger Yen, including the domestic consumption stocks. As a further tailwind for these companies, the government is floating the idea of delaying the second half of the Consumption Tax increase.

Surprise #4: Saudi Is Not Fracking Around. ***(Little Red Corvette)***

Realizing the end of the Hydrocarbon Era is approaching more rapidly than anticipated, Saudi abdicates their role as swing producer within OPEC and recommits to maximizing their production and grabbing market share. The resumption of Iran oil trading and short-term storage concerns push the market into steep Contango in Q1 and oil hits a multi-decade low in the 20s, but in the second half of the year the impact of cap-ex cuts and production declines push prices back toward $50.

Incremental consumption of oil is driven to a large measure by transportation fuel demand and the fact that global sales of little red Corvettes (and cars, generally) continue to show strength is a net positive for oil prices. The switch to muscle cars and SUVs (which always happens when gasoline prices fall) helps on the margin as well, but may not be as helpful this time around given the incremental demand for electric vehicles which reduce gasoline consumption. The swing factor today is Chinese car consumption, which took a dive earlier in the year, but has rebounded strongly, and long-term trends in that area are robust. The one big risk to this trend is a government decree that bans the internal combustion engine (this has been discussed) to fight pollution, and while the risks are low, they are not zero. One of the big drivers of an oil price recovery historically has been recovering demand as the result of lower prices (see Surprise #9, the cure for low prices is low prices), but since this oil move has been a supply shock (not a recessionary demand shock), this cycle may not play out as normal. It really could come down to the commitment by the Saudis to limit supply. The Saudis' conniving to bring down the U.S. shale producers brings to mind the witches around the cauldron in *Macbeth* chanting ***"Double, double, toil and trouble; Fire burn, and cauldron bubble!"*** While it may be true that the Permian basin in Texas has become the global swing producer because the speed of well completion has improved so much, OPEC hasn't lost all of their magic powers yet and the one big surprise to everyone would be if Saudi decided to cut production suddenly to drive prices back up. Why would they do that given their decision to try and drive them down? Perhaps they underestimated the ability of U.S. producers to cut costs as even at $30 a barrel there were not as many casualties as we would have expected. Perhaps they have concluded that their best play now is to maximize the value of their underground asset by taking Aramco public, and logically a higher oil price would drive a higher IPO value.

Oil did indeed trough in the 20s in Q1 ($26.21 on 2/11) as fears of oversupply hit a crescendo, but then suddenly (and very forcefully) turned on a dime on rumors of a pact between Saudi Arabia and Russia to cap oil production. The rally caught the shorts by surprise and a huge squeeze commenced that has caused the sharpest oil rally in history over the past two months. Adding some eye of newt to the cauldron, the Chinese suddenly began buying commodity futures at a level that was 3 times their previous peak volume and oil futures are reminiscent of S&P futures when QE was kicking in off the bottom in 2009, straight up and to the right with no volatility. Prices have surged all the way back to the high forties (our year-end target) and there are pundits now getting uber-bullish calling for $70 by year-end and some have even uttered the $100 number for 2018 despite the Saudi oil minister's statement a few months ago that oil would never again hit $100. The one person in the oil space that we actually pay attention to (translation, just about the only guy to have been right more than once over the past couple of decades), Pierre Andurand, may have been partially responsible for the bottom as he went on CNBC on February 10th and said that he had turned bullish (after nailing it by being one of the very few bearish voices back in 2014). Pierre upped his price target for 2016 to $60 to $70, sees $85 in 2017 and $100 in 2018 as he thinks the supply picture will erode very quickly in the next 24 months and that there could be as much as a 5 million barrel per day deficit in 2020. We are hearing rumblings out of the oil patch that might counter some of that enthusiasm (but we are cautious about disagreeing with a black belt mixed martial artist…), particularly that banks have extended credit to some companies they probably should have let fail and that well completions continue to improve in terms of speed. We believe both of these factors will reduce the supply decline. Anecdotally, one of our private investments in drilling just completed a well in five days, which is extraordinary on its own, but mind-boggling when you think that just two years ago a similar well in the same area took thirty days. We are also mindful that oil prices rallied from $44 to $61 from March to May 2015 before collapsing in the summer and fall to finish the year at $37. The current rally looks very toppy, so we would be cautious here, but we could see the 50s being a better year-end number than the 40s given new information from Andurand.

Surprise #5: The Black Swan Alights in Europe. ***(Take Me With U)***

The relentless bear market in commodities since 2011 comes to a head with a messy bankruptcy of one (or more) commodity trading companies (Glencore, Trafigura, Vitol, Nobel Group, and Mercuria). The resulting unwind of complex derivative positions causes huge losses within the European banks, pushing one or more of them to the brink of insolvency.

One of Prince's catchiest tunes is *Take Me With U* and it is a very useful title for so many things in investing. The actions of one group can essentially take an entire country, sector, or asset class along with them into success or failure. Examples run from government regulation Dodd-Franking the banking industry, declining oil prices sinking the Ruble and hence Russian equities, or the strong Dollar tanking commodities. Sometimes companies become so inextricably linked that the fortunes of one essentially become the fortunes of the other. Think Japanese components suppliers that got slammed in Q1 when Apple iPhone orders disappointed or (as in our Surprise) when the fortunes of European banks could be smashed by the unwinding of the commodity trading houses. We wrote last quarter that, *"We think there is some possibility that a similar situation to [the Banking Panic] described in our Q3 letter could be unfolding (Surprise #5 has eerie similarity). What we are not saying is that precisely the same series of events will occur and lead to a full-fledged panic, but given the similarities between then and now, particularly with role of the commodity markets (copper) and the leverage in the banking system (back then in the U.S., today in Europe) it makes sense to at least consider what could happen."* Clearly the fears have taken hold in the European banking sector this year with stocks down huge amounts and rumors swirling about capital deficits at some of the largest banks on the Continent. Deutsche Bank ("DB") and Credit Suisse ("CS") have been hit the hardest as fears of material loan losses related to commodities have materialized and investors have begun to sell with abandon. In fact, on my recent trip to London, short DB was the most popular trade across all the managers I met. Sometimes (but not always, as sometimes, albeit infrequently, the consensus is right) when everyone is on one side of the boat, it pays to start thinking about when to move to the other side.

Shakespeare had some important wisdom that applies to these situations. First, he wrote, ***"Tempt not a desperate man."*** *(Romeo and Juliet)* Desperate people will do desperate things which can prove very dangerous if you are on the other side of their actions. The most compelling examples of this wisdom's application to investing are on the short side. It is rarely a good idea to go short (or remain short if you have been fortunate enough to be early) when things get really desperate for a company (stocks), a government (currencies or bonds) or a Central Bank (all risk assets) as people with vested interests will always do what Mr. Draghi has made famous, *"whatever it takes."* A couple recent examples are Valeant stock and Deutsche Bank. In the VRX case, the most high profile shareholder (Bill Ackman of Pershing Square) has nothing left to lose, and is promulgating all kinds of creative moves to get relief from the debt holders (similar to the "magic" he achieved with General Growth Properties in 2009). In the DB case, it is a widely held view that Deutsche Bank is essentially a subsidiary of the German government, so even if they trip the CoCo bond covenants, a government bailout of some sort could cause the stock to soar like Citibank did in 2009 (from $1 to $5 in six short months), causing some serious pain to the shorts. Yes, DB is down (32%) this year on top of huge losses last year, but there is a point where the vested interests will likely intervene and that could be painful for the shorts. Similarly, the Bard wrote, ***"Press not a falling man too far!"*** *(Henry VIII)* Don't press a good short for the last nickel. For example, there are many who believe that Chesapeake (CHK), Glencore (GLEN.L) and Freeport-McMoRan (FCX) might be on verge of bankruptcy, but it would be inconvenient for way too many people for any actual bankruptcy to materialize, so those who stayed short these names this year got run over as they squeezed up between 100% and 300% (before giving some of those gains back in recent weeks as the Chinese stopped buying so many commodity futures).

We are still in the camp that there are more Acts in this Play and that we are still leaning toward the Tragedy ending rather than the Comedy.

Surprise #6: Déjà Vu, Welcome to #2000.2.0. ***(1999)***
The U.S. economy and equity markets have entered a challenging period resembling the unwinding of the Tech Bubble from April 2000 to April 2003, and 2016 closely resembles 2001 with the S&P 500 down in the low teens. Economic growth falters, corporate profits fall and equities begin a relentless decline that will last through the end of 2017.

We have digressed perhaps too much on how similar we believe the next few years will be to the 2000 to 2002 period in the global capital markets and how the U.S. equity market is priced to produce a negative real return for investors for the better part of the next decade. That said, investors are following Prince's advice from the song and saying, ***"Tonight I'm gonna party like it's nineteen-ninety-nine."*** In fact, instead of getting hedged in advance of what is likely to be a very challenging environment, some investors are actually selling hedge funds and moving money back into long-only and Index Funds. The most ironic part of this story is that these investors (like CalPERS and NYPERS) bought their hedge funds after the downturns in 2002 and 2008 (chasing the hot trailing returns during each crisis) only to suffer poor relative performance during the rebound periods. This performance chasing behavior is not limited to large Pension Funds, but many investors are unfortunately prone to buying trailing three-year performance when they should really buy trailing ten-year performance of firms that just experienced a very tough three years (mean reversion is a powerful, powerful force). As you have figured out by this point in the letter, Shakespeare had some wisdom about that too, writing, ***"He wears his faith but as the fashion of his hat; it ever changes with the next block."*** *(Much Ado About Nothing)* Investors tend to follow the fashion of the day and will jump to a new idea as soon as it emerges. This serial rotation has been exacerbated by HFT and now the constant flow of capital from sector to sector and country to country makes for a uniquely challenging investment environment for long-term investors (as opposed to traders). Some are pointing to the fact that 7/10 of the top paid hedge fund managers are Quants (computer traders) this year is proof that the machines have won and that the small investor has no chance in the market. We have seen this play before throughout the history of every innovation cycle. Those that harness the new innovation the best do have a short-term advantage over other investors, until the next innovation comes along.

The market plunge during the first six weeks of 2016 gave us a preview of what might lie ahead should the next three years play out like 2000 to 2002. That said, given the very poor relative performance of long/short strategies in Q1, there is still a lot of doubt in the marketplace about the usefulness of hedge funds within a portfolio (why should I pay all these fees when they can't beat Index funds?). We have seen this Play before, and we know how it ends. Whenever there is a bubbly period in the markets (like 1994-2000 or 2003-2008) investors collectively decide that hedged strategies are no longer important (precisely at the moment they are likely to need hedging the most). We wrote in Q3 that even A.W. Jones himself admitted to getting caught up in the euphoria of Nifty Fifty Era, as stocks soared to new heights every day, *"In a turn of phrase that was nearly heretical, Jones said* ***'I began to wonder whether our hedging strategies, which had always been aimed at softening the effects of a potential market decline, but which held back our gains in bull markets, might not have been misguided; perhaps it would have been smarter to have run at full risk all the time, thus taking maximum advantage of the general upward trend of the market.'"*** *Another manager referenced in the article, John Hartwell (who worked for a time for Jones), . . . summed up the challenge of being a hedged equity manager in a runaway bull market in saying,* ***"hedging is vastly overrated as a concept. People argue that there is***

psychological comfort in having a short position. I used to believe it, but I don't any more. I stopped believing it after we got bloody and beaten from short selling." If we removed the names, these words could have been lifted from the media any time in the past year, as there have been numerous articles and white papers questioning the value (and perhaps the sanity) of following hedged strategies in a QE world. The last time the relative performance of hedge funds was this bad was in Q1 of 2000; maybe a coincidence, maybe not.

In the equity markets, gains most often happen slowly and losses usually happen quickly. You can see this in the numbers, as the average bull market is much longer than the average bear market (more than five times longer at 97 months versus 18 months). Therefore, it is critical to always be looking for long opportunities, especially during the brief corrective periods (when things go on sale). To reiterate a point we have discussed in prior letters which was a paraphrase of the line from *The Merry Wives of Windsor*, *"The essential problem that we highlighted last quarter is that when it comes to bubbles and crises, you can be a few hours early, but you can't be one minute late."* We have always believed that the superior solution for managing equities is to follow the A.W. Jones model of investing, to always be hedged and reap the benefits of gaining exposure to the equity markets in this manner. The benefit of swapping long/short equity for long-only equity is that over the long-term you get equivalent (or even superior) returns and all you have to give up is volatility and risk (a good trade). Most importantly, that lower volatility reduces the emotional roller coaster linked to investment portfolio volatility that can cause average investors to sell at the bottom (crystalizing the loss), and impair the power of compounding over time. In investing, there are times to keep partying, and we agree with Prince that this is not one of those times. Just putting some numbers on this, GDP growth in the U.S. is declining (at an accelerating pace), corporate profits are down (5%) and corporate revenues are down (1.6%) year-over-year (both of which have always been associated with downturns). It is important to remember that the eighth year of a Presidential cycle has been a big negative, averaging down (14%).

Surprise #7: Dragons & Tigers Beat Bears, Oh My!
(Let's Go Crazy)
Emerging Markets divide into two very different groups based on whether they are commodity producers or commodity consumers. Producers (Brazil and Russia) continue to struggle with budget deficits and pervasive currency weakness, while Consumers (China and India) enjoy the tailwinds of lower inflation and higher growth courtesy of lower commodity prices, and the Dragon and Tiger markets beat the Bear and finish up for the year.

Being a Bull on Emerging Markets (and "Chindia" in particular) has been known to elicit labels borrowed from Prince's song title (or worse), as the average investor believes it is truly crazy to want to invest in EM broadly, and China or India specifically, in the current environment. We have always been prone to being a little early by going back into markets after a difficult period as our value bias tends to push us toward places that are cheap. Cheap places usually got that way by having poor performance in the most recent period, which tends to turn investors away. This process continues to make them cheaper (in reflexive manner). Clearly we have been early in China and India this year. The real story in EM has been the strong rebound of Brazil and Russia on the commodity strength in the first quarter. For perspective, during the first four months of the year (with EEM up about 2%) China was down (9%) and India was down (3%), while Russia rallied 15% and Brazil surged 35% (on the heels of rapidly recovering iron ore prices).

Early is sometimes a euphemism for wrong. However, we think the macro trends in these markets are too great to ignore, and that they will swamp the short-term negative sentiment around EM and the Chindia markets. Shakespeare has a powerful line on the power of big movements, ***"This making of Christians will raise the price of hogs."*** *(The Merchant of Venice)* Economics is an amazingly simple construct, supply and demand work. If more people want something with a limited supply, the price will rise (and vice versa). The character Shylock is Jewish, and laments how the increase in the number of Christians (who are allowed to eat pork) will raise the demand (and therefore price) of pigs. In investing, following this simple idea can be very profitable, allowing investors to get in front of emerging demand. Today, one of the most robust investment opportunities is to get in the path of progress, as the emergence of the middle class consumer globally will raise the price of goods and services. The simple summary from one of our favorite managers (Arisaig Partners) is to focus your investment dollars on owning companies that produce goods/services to Eat, Drink, Wear, Wash and Shop in the developing markets (particularly Asia and Africa). Demographics are destiny and we expect the equity markets to follow the demographic trends in the years ahead. There is one risk to the bullish view, and we will speak to that in the next section.

Surprise #8: King Dollar Gets Dethroned.
(I Could Never Take the Place of Your Man)
Contrary to the powerful narrative that the U.S. Dollar must continue to appreciate in the face of the Fed taking a different course with monetary policy (or at least threatening to take a different course) than the ECB & BOJ, the old saw "Buy the Rumor, Sell the News" turns out to be true once again; the USD peaks and actually begins to weaken against other global currencies. The surprising Dollar weakness takes some pressure off of the Chinese to further weaken the RMB and the Yuan continues on a path toward becoming a World Reserve Currency.

I have often quipped that Americans are like Notre Dame football fans, they remember a past that never was. The Prince song title sums up a similar sentiment. ND fans believe that their team wins the championship every year (actually haven't since 1988) in the same way that Americans can't remember the time when they weren't the global Super Power. Both are mistaken. ND was indeed nearly unbeatable in the 1940s when Coach Leahy went over to Europe during the war and recruited the boys from Army and Navy to come back to ND and those 28 year olds were like a semi-pro team (don't get to do that anymore, except at BYU). Americans can't recall the days when the U.S. was an emerging market and the U.K. was the global Super Power (and the Pound was the world reserve currency). As Shakespeare so eloquently said, ***"Uneasy lies the head that wears a crown."*** *(Henry IV, part 2)* The person/company/country/currency at the top must always rest uneasy because someone else wants that spot; eventually the crown is always lost. To that point, we said it first back in January that King Dollar would be dethroned, and the RMB would start nipping at the heels of the World Reserve Currency. Regimes change. So far in 2016 there has been some incremental movement in the currency status quo as the Dollar (DXY) has fallen from 98 to 94, the Euro has risen from 109 to 114, the Yen has strengthened from 121 to 107 while the RMB has been actually risen slightly from 6.48 to 6.50 (despite the clear consensus that it was headed to 7 or 8).

These days, wars with troops are rarer, and wars between Central Banks over currency dominance are more frequent. With the race to debase in full force, a quote from *Titus Andronicus* seems fitting, ***"O, why should nature build so foul a den, unless the gods delight in tragedies?"*** This play clearly must have been written in one of Shakespeare's darker (or maybe drunken) moments and we won't delve too deeply into the plot (pretty much everybody dies), but the crux of this quote is that the conflict between the warring families has escalated to such a level that Marcus Andronicus poses the question that why would nature (abdicating their family responsibility, of course) allow such a "fine mess" to evolve unless the gods liked to watch the tragic theater. When looking at the current currency wars, one might say the same thing. How did we get here unless the gods delight in tragedy? When engaged in a race to the bottom, there really are no winners (pretty much everybody dies). The temporary cease fire called by Ms. Lagarde is a step in the right direction as the #ShanghaiAccord has stopped the bloodletting (for now) and taken the pressure off the Chinese to devalue the RMB (for now), which is good news because the global equity market reaction to even the slightest adjustment to the Yuan was as if each cut hit an artery. An apt visual for this comes from the scene in the Reduced Shakespeare production where one of the actors playing Lavinia (Titus Andronicus' daughter who has her hands cut off and her tongue cut out so she couldn't identify her attackers) spurts ketchup all over the stage from his bandaged arms.

We have said for many quarters that the most important decision to get right in investing is the direction of the Dollar because so many other assets are so tightly correlated to the Greenback's direction (perhaps the Dollar should have the *Take Me With U* song title). Whether it is Gold, Oil and other commodities having been in a Bear market since 2011 as the Dollar strengthened or whether the prospect of the RMB having to do a major devaluation because they are pegged to the rising Dollar, getting the Dollar right is critical to investment success in the current environment. So even though it appears that the DXY Index gave up its throne and peaked last year (and is down nicely in 2016), which has led to a major rally in commodities and Emerging Market equities, if QEeen Janet abdicates her throne, turning to the hawk side by raising rates (negating Surprise #2), the Dollar would likely rally. Any meaningful rally would put renewed pressure on the RMB. If the stress rose to extremes and forced the Chinese to take their medicine all at once (instead of their incremental prescription) then the currency wars, and global equity markets, would look very much like the final scene in *Titus Andronicus* than we would like.

Surprise #9: Cure For Low Prices Is Low Prices. ***(U Got The Look)***

The severe Bear Market in Commodities that began in 2011 destroys sufficient industry market, capitalization spurring companies to dramatically slash capital spending, cancel large swaths of projects, and reduce productive capacity to a point where commodity prices begin to find a floor. Some generational investment opportunities would then arise amidst the bankruptcies and restructurings in places like MLPs, Miners and Exploration & Production companies.

We know beauty is in the eye of the beholder and Prince gives us a great hook in *U Got The Look* that reminds us that any asset can be attractive at the right price. After a long Bear market in commodities from 2011 to 2015 and substantive declines across the board, it appears that commodities got the look in 2016 as investors began to tiptoe back into Gold, Oil, Iron Ore, Copper and others in late January. That tiptoeing turned into an all-out dash toward the end of the quarter, and there were some moves in the commodity complex that were (to use an adjective from Prince's song) *Slammin'*. It appears that great investors like Howard Marks, George Soros and Arjun Divecha all got their material on this topic from Shakespeare who wrote, ***"So quick bright things come to confusion."*** *(A Midsummer Night's Dream)* When things are a mess and there is utter chaos and confusion, it doesn't take much to bring things back towards order. In investing, George Soros described this sentiment saying, *"The worse a situation gets, the easier it is to turn it around and the greater the upside."* One of the best strategies to making big returns is to go looking for areas of dislocation (bombed-out markets or sectors), and buying the assets that are "on sale." I have often quipped that investing is the only business I know that when things go on sale, everyone runs out of the store (seemingly everyone, except David Tepper). David has an extraordinary track record of success at Appaloosa (so extraordinary that when he decided to move to Florida New Jersey had to change the tax code…) using this simple idea of buying assets that are beaten down when he can see a catalyst that will trigger a reversal. Interestingly, David just bought a boatload of MLPs in the past few months.

There are lots of great ideas in the commodity complex today from oil and gas related equities to oil and gas directly in the ground, from gold and silver to the miners that produce the precious metals, from the survivors in the iron ore business in places like Brazil to the survivors in the coal business in the U.S.. It turns out that if most of the companies in an industry go bankrupt, supply goes down and the survivors become quite profitable. In the first four months of the year, the commodity complex has become the "Pain Trade" as many were underweight coming into the year and missed the beginning of the rally, forcing them to pile on late (which drive prices higher in a reflexive fashion). Now with the little wiggle down, as the other Fed Presidents besides Ms. Yellen jawbone about higher rates and the Dollar has a little surge, we will see how durable this trend really is. For some perspective, the CRB Index began the year at 176, fell all the way to 155 on 2/11 before rallying up to 180, and settled now right where it started. Iron Ore started the year at 41 and surged all the way to 61 before falling back to 56. Copper was 210 to begin the year, rallied up to 230, and has since fallen back to 207. Gold has been the best performer starting at 1,060 and rising pretty steadily to 1,254. Interestingly, Stan Druckenmiller loaded up on gold at the end of last year (rumors of 30% or more of his very substantial assets) and spoke at the Sohn Conference about the impending collapse in the financial system where gold could be multiples of where it is today.

Surprise #10: The Bus Stops Here… ***(Purple Rain)***
Uncle Carl Icahn is right and there is Danger Ahead in the credit markets around the world. Excess Central Bank liquidity has created a bond bubble across myriad sectors and there are abundant opportunities to short credit in emerging markets, high yield (particularly energy) during this new distressed debt cycle.

Prince said that *Purple Rain* symbolized blood filling the blue skies and letting God lead you to the heavens at the end of the world. Maybe a little heavy for this letter, but applying the core idea to the fact that there are times when companies make poor capital allocation decisions, and reach the end of the line. Shakespeare's take on the same theme was ***"We are such stuff as dreams are made on, and our little life is rounded with a sleep."*** *(The Tempest)* Even the best companies (that accomplish the success of which everyone dreams) have a finite life and will eventually shuffle off this mortal coil as competition takes over, management executes poorly, the economic environment changes or any number of other reasons for failure. The problem with debt bubbles is that they build slowly and end rapidly, and most investors never seem to see them coming which can lead to significant losses. We wrote about this in last quarter's letter, and I will repeat that section here, as things haven't changed much in how we see this market heading toward a cliff. *"When credit becomes abundant and the cost of capital plunges, increasingly poor collateral is taken against loans. The real danger lies in the risk that an adjustment in the price of that collateral leads to margin calls and an unexpected unwinding of leverage. The deleveraging can quickly become disorderly when the system is too interconnected. We have seen this scenario play out many times over the last century, most recently during the Tech/Telecom bust in 2001-2002 and during the Global Financial crisis in 2007-2008. In 2001 it was "square inch real estate" (fiber optic cable) and in 2007 it was subprime mortgages. In the most current debt boom it was commodities again (primarily copper and oil) that became the collateral for explosive lending in the U.S. (shale oil & gas), China (copper), and Europe (commodity trading companies). Credit booms eventually lead to credit busts and we have heard warnings from some of the best investors in the world including Carl Icahn's infamous video released last year entitled Danger Ahead that discussed the impending perils of high yield debt (much of it backed by commodities).*

What did change since last time was the evaporation of fear about the risks of this impending problem and investors rushed back into high yield bonds in near record amounts in the later part of Q1 and pushed prices back to the silly levels we saw at the end of last year. We would not expect to see prices at these levels a year from now and still believe there are better short opportunities than long opportunities in credit.

Bonus Surprise: Unicorns Have Ten Lives. ***(Kiss)*** Contrary to the drumbeat of negativity that too much money went into venture backed start-ups in 2015, pushing up valuations to levels triggering the mocking moniker "Unicorns," disruptive innovation continues to emanate from Silicon Valley and Route 128 in Boston and late stage venture generates superior returns for investors.

"You don't have to be rich to be my girl. You don't have to be cool to rule my world. Ain't no particular sign I'm more compatible with I just want your extra time and your…Kiss." Prince keeps it simple and so do the best venture investors. Great ideas can come from anywhere and while they don't have to be cool to rule the world, many of the technologies today are indeed very cool. Shakespeare wrote the perfect line for this Surprise, ***"Now I will believe that there are unicorns…"*** *(The Tempest)* Some derisively call the most successful tech companies Unicorns (mythical creatures). Alas, these companies do actually exist, and they are literally changing the world in which we live. We believe it is very profitable to invest in #DisruptiveInnovation.

UPDATE ON MORGAN CREEK

We hope you have been able to join us for our Global Market Outlook Webinar Series entitled "***Around the World with Yusko***." We have had many interesting discussions in the last few months including: *The Fed Coin Flip: Heads We Lose, Tails We Lose, and Yuan a Piece of Me? China Plays Hard Ball with the Hedgies*. If you missed one and would like to receive a recording, please contact a member of our Investor Relations team at IR@morgancreekcap.com. Mark your calendar now for our **May 31** webinar **at 1:00pm EST,**

We are also a proud sponsor of The Investment Institute, a newly formed Educational Membership Association for Institutional & Private Investors and Managers in the Southeast. The Investment Institute is in the process of renewing its members for 2016. The date of the next program will be May 23-24, 2016 at The Umstead Hotel in Cary, NC. For more information on how to become a member and join this elite group please visit www.theinvestmentinstitute.org or contact Andrea Szigethy at andrea@annualconnect.com or Donna Holly at donna@annualconnect.com.

As always, It is a great privilege to manage capital on your behalf and we are appreciative of your long-term partnership and confidence.

With warmest regards,

Mark W. Yusko

Mark W. Yusko
Chief Executive Officer & Chief Investment Officer

General

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Russell 3000 Index (DRI) — this index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. Definition is from the Russell Investment Group.

MSCI EAFE Index — this is a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the US & Canada. Morgan Stanley Capital International definition is from Morgan Stanley.

MSCI World Index — this is a free float-adjusted market capitalization index that is designed to measure global developed market equity performance. Morgan Stanley Capital International definition is from Morgan Stanley.

91-Day US T-Bill — short-term U.S. Treasury securities with minimum denominations of $10,000 and a maturity of three months. They are issued at a discount to face value. Definition is from the Department of Treasury.

HFRX Absolute Return Index — provides investors with exposure to hedge funds that seek stable performance regardless of market conditions. Absolute return funds tend to be considerably less volatile and correlate less to major market benchmarks than directional funds. Definition is from Hedge Fund Research, Inc.

JP Morgan Global Bond Index — this is a capitalization-weighted index of the total return of the global government bond markets (including the U.S.) including the effect of currency. Countries and issues are included in the index based on size and liquidity. Definition is from JP Morgan.

Barclays High Yield Bond Index — this index consists of all non-investment grade U.S. and Yankee bonds with a minimum outstanding amount of $100 million and maturing over one year. Definition is from Barclays.

Barclays Aggregate Bond Index — this is a composite index made up of the Barclays Government/Corporate Bond Index, Mortgage-Backed Securities Index and Asset-Backed Securities Index, which includes securities that are of investment-grade quality or better, have at least one year to maturity and have an outstanding par value of at least $100 million. Definition is from Barclays.

S&P 500 Index — this is an index consisting of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The index is a market-value weighted index – each stock's weight in the index is proportionate to its market value. Definition is from Standard and Poor's.

Barclays Government Credit Bond Index — includes securities in the Government and Corporate Indices. Specifically, the Government Index includes treasuries and agencies. The Corporate Index includes publicly issued U.S. corporate and Yankee debentures and secured notes that meet specific maturity, liquidity and quality requirements.

HFRI Emerging Markets Index — this is an Emerging Markets index with a regional investment focus in the following geographic areas: Asia ex-Japan, Russia/Eastern Europe, Latin America, Africa or the Middle East.

HFRI FOF: Diversified Index — invests in a variety of strategies among multiple managers; historical annual return and/or a standard deviation generally similar to the HFRI Fund of Fund Composite index; demonstrates generally close performance and returns distribution correlation to the HFRI Fund of Fund Composite Index. A fund in the HFRI FOF Diversified Index tends to show minimal loss in down markets while achieving superior returns in up markets. Definition is from Hedge Fund Research, Inc.

MSCI Emerging Markets Index — this is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. The MSCI Emerging Markets Index consisted of the following 23 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates.