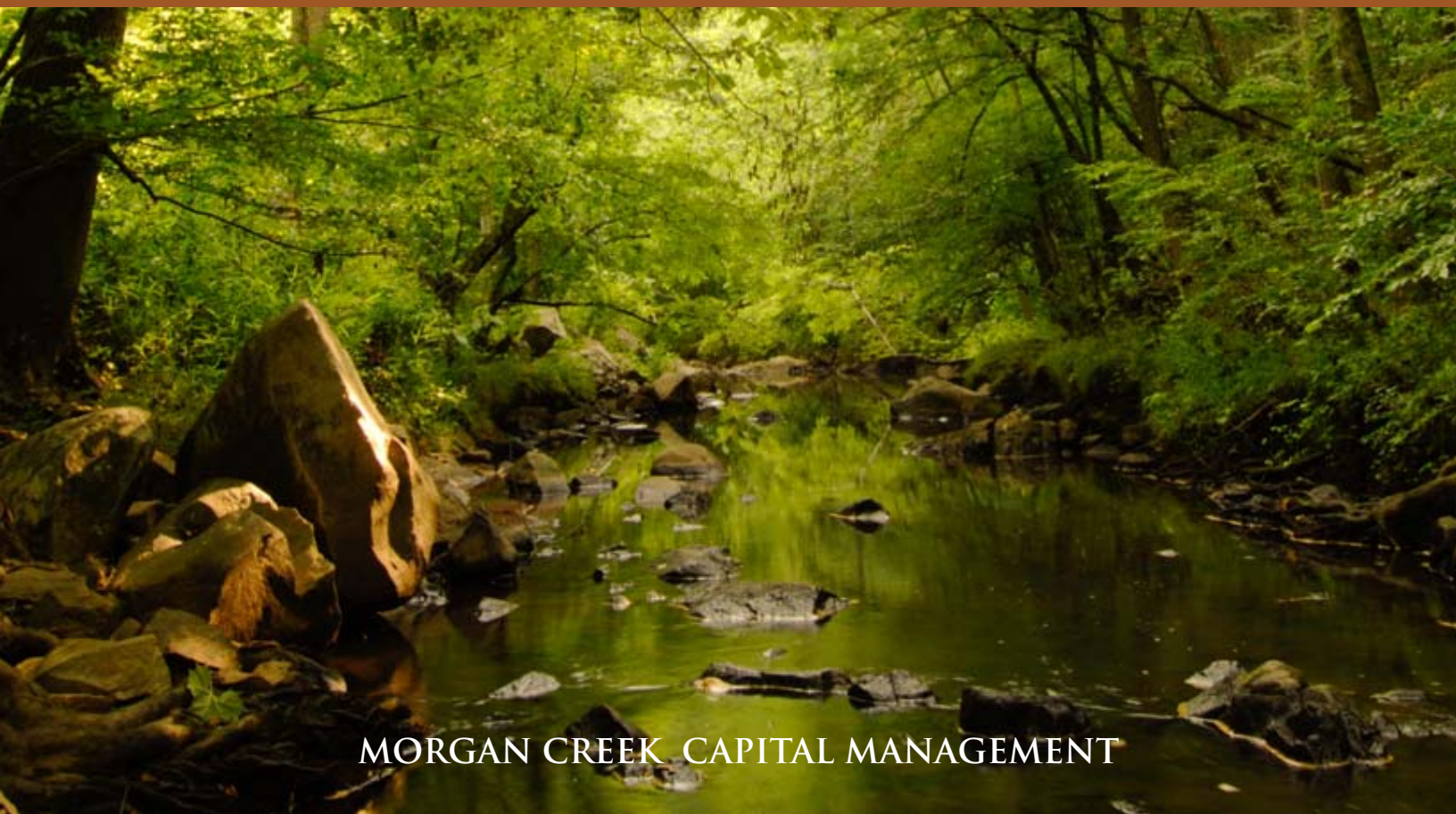




Q2 2015 MARKET REVIEW & OUTLOOK

Morgan Creek Capital Management



MORGAN CREEK CAPITAL MANAGEMENT

LETTER TO FELLOW INVESTORS

GREECE IS THE WORD AND UNLOOSING THE NEW GORDIAN KNOT

It seems a little funny that a country with a population equal to Ohio (11 million) and a GDP equivalent to Oregon (\$240 billion) was all anyone wanted to talk about in Q2. The news media was saturated with stories about the Greek Crisis and it seemed that just about every other weekend there was another emergency EU Summit to determine whether to force Greece out of the Euro and/or the Eurozone (the proverbial #Grexit) or give them a third bail out. We even dedicated the May Around the World Webinar to the topic, titled *Hotel California Encore: Why Europe Won't Allow a #Grexit* and quoted the iconic Eagles song in saying that Euro participants in the PIIGS (Portugal, Ireland, Italy, Greece and Spain) could “check out any time they like, but they could never leave” because any exit from the Euro would disrupt the German master plan of global domination through cheap exports, which requires a weak currency (the Deutschemark would be 40%+ higher than the Euro today). A weak Euro requires all the PIIGS to stay in the trough so they can't devalue their own currencies and steal exports from Germany (and France). Many have long accused the Chinese of “manipulating” their currency in order to promote their plan of Mercantilism (selling cheap goods around the world), but the Germans make the Chinese look like rank amateurs in the Mercantilism contest since the advent of the common European currency. One way I have measured this phenomenon is anecdotal in that a few years ago we had three Japanese cars in our garage and now we have three German cars because up until 2013 the Japanese weren't fighting back in the global currency wars (they have clearly changed their posture with Abe-san and Kuroda-san, but more on that later). As I travel around the world I make it a habit to count the German cars wherever I am and it is astonishing how dominant the big three German brands (Mercedes, Audi & VW) are from the U.S. to Europe, from Latin America to China and everywhere in between. Even in places where you wouldn't expect to find lots of German cars, like Greece, they have lots of German cars (as I observed on my recent vacation there, more on this trip in a moment) because the depreciating Euro has made the price attractive enough to overcome the negative feelings that the Greeks have toward the Germans today (and by the way, the feeling is mutual).



Source(s): WorldBank.org

So a year ago Stacey signed us up to take a cruise around the Greek Isles this summer as our first solo trip without the little man. Little did we know that we would be headed right into the middle of a crisis zone. Over the past few months, people would ask if we were still going and our standard response was unless they cancel the trip, we are going. As the departure date drew closer we were warned that it would be unsafe because of riots, that we should take lots of cash because the ATMs wouldn't work, that we wouldn't be able to get to the hotel from the airport because the cabs were on strike, that our credit cards wouldn't work because the banks were closed, that there wouldn't be any food in the restaurants and myriad other reasons why we should just go to Topsail Beach instead. We set out a month ago and flew to Athens through London and other than a too long layover, the trip went very smoothly and when we arrived the airport was bustling, the currency exchanges were offering a “special deal for Dollars” and the line of cabs was a hundred deep. I actually started tweeting observations of the trip upon arrival (you can find them in my Twitter stream @MarkYusko, or search for #Grobobservations) and the first things we noticed were that there was no sense of panic anywhere, no long lines at the ATMs, traffic was healthy and the hotel lobby was busy when we arrived. We stayed at the Hotel Grande Bretagne (have to say one of the nicest hotels I've been to and their rooftop restaurant overlooking the Acropolis is a Top Ten dining venue), which is

right across from the Parliament Building and there were no protests, no riots, in fact, no activity of any kind (it was about 7:30 PM to be fair). Our cruise didn't depart until Saturday AM and the welcome dinner was Friday evening, so I seized the opportunity to spend Friday doing meetings with Greek investors, Bank Management teams and research firms (Hotel Spa = Hall Pass) and with the help of a couple of our great manager friends at Sandglass and Falcon Edge, I was able to book a great day.

Friday started with breakfast with a family office executive from one of the largest Greek families (they sold their agricultural business to a private equity firm for a lot of money years ago) and we spent time talking about how they were deploying capital around the world and whether they saw any opportunities in Greece. Their perspective was that it was too soon to deploy meaningful capital in the Greek public markets yet (Banks were still closed and capital controls are expected for some time), but they had a shopping list of a handful of great businesses that they believed would be great buys when markets reopened. Next up was a meeting with the CFO of one of the largest Banks and that was a little bit of an eye opener as it was actually a little disconcerting to walk up to the bank headquarters and see the metal gates shut and locked and have to be escorted by an armed guard into the building. Once inside it was a little eerie in that the building was essentially empty, but the CFO and his Controller had made a special effort to come in and meet with me (which was much appreciated). The best adjective to describe the meeting was somber, as he explained why the current capital controls situation did not have to happen and was the result of vindictiveness over the debt negotiations (essentially that things got personal). He also believed the Banks would be forced to take too much new capital based on a future Stress Test that he described would be “managed to fit the conclusion.” From there I had the great privilege to meet with the CEO of the largest Bank and that meeting was the highlight of the day. Again, I was escorted in by a guard and taken to the executive suite where it was very quiet, just me, the CEO, two assistants and four guards. He could not have been more engaging and generous with his time (we spent nearly 90 minutes talking) and we covered everything from Politics (he is a huge Tsipras fan and thinks he is an amazingly talented leader, who did the right thing for the long-term and truly cares about Greece and the Greek people), to the New Deal (he thinks that Austerity is not the answer, why do more of what is not working), to Bank Restructuring (he warned that wiping out the foreign shareholders like Wilbur Ross and Paulson would be a huge mistake), to Entrepreneurship (he thought my idea to start a new bank was an “excellent idea” and he had a number of ideas on where we could get a license and how to capture some of the \$50 billion hidden in the mattresses around the country) and Greece (he said this is not the first time they have had to overcome adversity and that they would emerge stronger on the other side). Our conversation was so engaging that I didn't want to break away, but had to head to lunch with the head of the Hellenic Financial Stability Fund (HFSF).

The HFSF is the Greek arm of the European Financial Stability Facility (EFSF), which is the operating Fund of the European Stability Mechanism (ESM). The Fund was created during the last crisis in 2010 to serve as a vehicle to contribute to the stability of the Greek banking system and was funded with \$50 billion between 2012 and 2014 from the EFSF. Over the course of the first set of bank restructurings, the Fund injected capital into the banks in exchange for ownership percentages between 40% and 65% (depending on the amount of private capital raised). Our conversation over lunch centered on the likelihood of another round of bank recapitalizations and the extent by which the HFSF and other entities in the EU would participate. It was clear that the mandate being handed down from Brussels was that the upcoming Asset Quality Review would be “poor” (no matter what the data said) and that existing shareholders would suffer material losses. The challenge was the circularity of the problem in that the EFSF would end up diluting themselves (since they funded the HFSF, clear as mud, right?) and that it would be months before there would be any real clarity on the actual plan. One thing that was clear in his mind was that

when the markets reopened, many investors would sell their bank stocks first and ask questions later, which is precisely what happened a few weeks later (the banks opened limit down (30%) for three days in a row before stabilizing in the last few days). The final meeting of the day was with a private equity research group that hedge funds (including Paulson and others in the U.S.) use to gather intelligence on the ground in Greece. The Principal of the firm was very entertaining and had lots of great stories about individual companies that he thought were incredible buys and a few that he wouldn't touch with a ten foot pole. We talked about how most global investors really didn't take the time to dig in to individual companies, but were rather playing Greece in a more Macro way, risk on, or risk off. He said that behavior created compelling opportunities for long-term investors who were willing to look beyond the next few months and focus on positives like record tourism (thanks to weak Euro), low labor costs (high unemployment) and an incredibly important geopolitical location of Greece in the center of everything from Europe to Russia to Asia. I could not have asked for a better, more informative day and there are a number of investment opportunities that will emerge from these meetings.

That evening we had an amazing dinner at the foot of the Acropolis (oh, by the way, my waistline will confirm that the idea there wouldn't be food in the restaurants was crazy talk) and as I looked up at this majestic edifice that had been standing for the better part of 2,500 years, it hit me that this was not Greece's first rodeo and they would endure, again. We boarded the ship the next morning and headed out for an amazing week visiting ancient sites in Delphi, Butrint (Albania, because of maritime law, a cruise must stop in two countries, who knew?), Nafplio, Corinth and Patmos and one day of tourist fun in Santorini (with a gazillion other people). I picked up some things along the way that will be helpful as I think about investing in writing this letter. In Delphi, we visited the Temple of Apollo and saw the Omphalos (the navel of the world) which is the point at which two eagles released by Zeus to circle the globe met and was believed to be the precise center of the world. The Omphalos stone was believed to allow direct contact with the Gods and the Oracle of Delphi was located here and people from all over the ancient world would come to Delphi to learn their fate by asking the Oracle questions (some also say the oracles were high from chewing on medicinal herbs and inhaling gas from a fissure and simply spouted nonsense). One of the takeaways was that investors still love the idea of Oracles, people who can predict the future, but we lean more toward spending time with people on the ground doing diligence to unearth good investment ideas. We learned that Corinth, not Athens (University town) was the real center of the Greek world for many centuries because of its geographic importance and the ingenuity of the locals to construct a land bridge across the Isthmus so merchants could avoid the treacherous waters at the tip of the Peloponnese Peninsula. This central location further solidified the construct that Greece was much more important from a Geopolitical perspective than its population or GDP would warrant. Finally, in Patmos we visited the cave where St. John wrote the last book of the New Testament, The Book of Revelation (The Apocalypse). I thought it was a fitting end to the trip as L'Apocalypse fits very well with our Four Horsemen of the #Growthpocalypse theme to be discussed later. Ten days in Greece went by far too quickly, but it was an amazing whirlwind tour full of historical lessons, modern day observations and compelling investment insights that we will pursue in the quarters to come.

We actually anticipated that Greece would be the word this year because the stars were aligned for an epic battle between the Troika and the Greeks as a number of debt repayment deadlines were looming and the newly elected government had sworn to take up arms against the Austerity Oppressors. In a bold move in January, the radical left Syriza party, led by charismatic Prime Minister candidate Alexis Tsipras, was able to engineer early elections and ride a wave of anti-austerity, populist sentiment to win a stunning victory and oust incumbent Antonis Samaras and the center-right New Democracy party. Pundits around the world immediately predicted that the Marxist leanings of Syriza, and Tsipras' lack of political experience, would plunge the Eurozone (and maybe global

capital markets) into a crisis rivaling the Global Financial Crisis. Keeping in mind that the scale of Greece's problems (\$320 billion of debt) relative to the size of global capital markets (more than \$300 trillion) and, more importantly, that only a small fraction of the overall debt was coming due in 2015, we posited that perhaps the "Crisis" was more of a Tempest in a Teacup. We went further in thinking about Greece in our 10 Potential Surprises list in January and predicted that in a reversal reminiscent of Brazil in 2002 (when the pundits predicted the world might end if the radical leftist, Lula was elected) that Tsipras would do a #LulaPivot and move more toward the center in order to try and truly lead Greece through this challenging period. Our hypothesis is that in politics, there are really only two "parties," In Power and Out of Power, and when you are Out of Power, you do, or say, whatever it takes to get elected and when you are In Power, you do, or say, whatever it takes to stay in power. Given the events of the past few months, it appears that this is precisely what happened and Alexis moved decidedly toward the center-left (so much so that the extreme part of Syriza has cleaved away) and has solidified himself as a very popular leader. Perhaps the most impressive part of the transition is that Tsipras has maintained an extremely high level of popularity (68% approval rating) despite a number of political missteps and a series of unfortunate events that left Greece with the banks being forced to close, the initiation of capital controls and the closure of the stock market for five weeks. The end result of that series of events is that the second part of our Surprise, that Greece would be one of the best performing markets in 2015, is now highly unlikely as the banks are likely to be forced to recapitalize and that will wipe out a large portion of the equity value (and the banks make up a meaningful portion of the market cap of the Index).

The short version (of a really long story) is that Tsipras made a poor choice in his Finance Minister, Yanis Varoufakis, as his abrupt, arrogant style did not sit well with the Troika (especially the Germans) and what should have been a fairly simple "Extend and Pretend" game plan for the Greek debt turned into a game of chicken when both parties decided not to blink. As the deadline for a technical default approached, Tsipras did make a good decision and fired Varoufakis (for a kinder, gentler Finance Minister), but it was too late and the Germans had already decided to "make an example" of Greece to dissuade any of the other PIIGS from getting any ideas about an exit, or debt forgiveness, or a reduction in Austerity (or anything else that would be a good idea, for that matter). Faced with the daunting task of having to negotiate against 18 heads of state of the EU (and some very nasty Finance Minister minions) Tsipras channeled a little bit of Alexander the Great when he attacked the Gordian Knot and made a bold, and completely unexpected, move by calling a Referendum to let the people voice their support for standing up against the failed policies of the Troika that they insisted on continuing to inflict upon Greece (rather than seeking a more forward looking solution). In one sense the gambit worked in terms of solidifying Tsipras' position as Prime Minister as the Greek people rallied behind their young leader and were willing to go to battle against the Troika (now it looks unlikely that he will be ousted in a new election). Unfortunately, the end of the story is not quite as good as Alexander's as the Germans did not retreat and ultimately Tsipras was forced to concede the battle and accept an Austerity proposal that many believe was inferior to the one he rejected before the Referendum. That said, there is another group that believes that Tsipras may not have lost the war, in that the new program provides three years of breathing room (versus five months in the original) and there are some who believe that there will be ongoing pressure from other countries (like the U.S.) to consider adding some form of debt relief/restructuring once the program is executed in the fall. The biggest question today is whether Greece now finds itself trapped in a new version of the Gordian Knot, tied unmercifully to the Austerity ox-cart, and subject to another period of "occupation" by the EU like the Roman or Ottoman Empire periods throughout their history.

The Gordian Knot is a legend associated with Alexander the Great that is often used as a metaphor for an

intractable problem, solved by a bold stroke. During the heroic age of Greek mythology, Phrygia was the dominant kingdom in Asia Minor (what is Turkey today) and was a close ally of the Trojans. At one time the Phrygians were without a king and an oracle decreed that the next man to approach the temple driving a cart should become their king. A peasant farmer named Gordias drove an ox-cart into the city and was declared king. Out of gratitude, Gordias and his son Midas (who would later become king and purportedly could turn anything he touched into gold) dedicated the ox-cart to the Phrygian god Sabazios (same as Greek god Zeus) and tied it to a post near the temple with an extremely intricate knot of cornel bark with the ends tucked tightly away inside. An oracle later foretold that anyone who untied the knot would rule all of Asia. Many tried to undo the knot to no avail. In 333 B.C. Alexander the Great invaded Asia Minor and came to the town of Gordium. Alexander was undefeated in battle (a mantle he would carry throughout his life), but lacked a decisive victory and desired an omen to show his troops (and more importantly, his enemies) that his mission to conquer the entire known world was indeed possible. Alexander ascended the acropolis and approached the cart tied to the temple under the watchful eye of a crowd of Macedonians and Phrygians. The crowd grew anxious as Alexander intently struggled with the knot and became frustrated. Alexander suddenly stepped back from the cart, called out, "What does it matter how I loosen it?" He then drew his sword, raised it above his head and with one powerful stroke severed the knot. That evening, a huge electrical storm raged which Alexander's supporters conveniently interpreted to mean the gods were pleased with the actions of this "Son of Zeus" who had solved the problem of the Gordian Knot.

Alexander III of Macedon (commonly known as Alexander the Great) was a King of the ancient Greek kingdom of Macedon. Born in 356 B.C. to Philip II and Olympias, legend has it that his mother dreamed that her womb was struck by a thunderbolt and Plutarch (the Greek biographer) interpreted this to mean that Alexander was a son of Zeus. He ascended to the throne at the age of 20 when his father was assassinated and spent the majority of his ruling years on an unrivaled military campaign throughout Asia and Northern Africa pursuing his father's Panhellenic Project to conquer Persia. Alexander was never defeated in battle, despite oftentimes being significantly outnumbered by his rivals, and by the age of 30 he had assembled one of the largest Empires in antiquity that stretched from Greece to Egypt to the edge of India. Alexander sought to conquer the territory that would reach "the ends of the world and the Great Outer Sea," but was forced to retreat from India because of lack of food in the desert and was dealt a crushing blow in losing 15,000 men to starvation (more than he lost on the battlefield in his entire career). He died in 323 B.C. in Babylon, the city he planned to establish as the capital of his Empire. Without his strong leadership, his kingdom was torn apart by civil war. Alexander's legacy was preserved in the twenty cities he founded (most famously Alexandria in Egypt) and by the spread of Greek culture in the East through the establishment of a new Hellenistic civilization, which significantly influenced the Byzantine Empire through modern times. Alexander the Great was a classical hero of epic proportions and has been considered the greatest military commander of all time. He is the standard against which military leaders hold themselves and military academies still teach his strategies and tactics to this day. Alexander is often cited as one of the most influential people of all-time, right next to his mentor, Aristotle. Alexander said ***"I am indebted to my father for living, but to my teacher for living well"*** and we can take great wisdom from Aristotle and Alexander the Great that we can apply to investing.

One of the things that I tweet about often is #Edge and how it is critical in investing to have an edge in order to be successful. Given the unparalleled success of Alexander the Great it is clear that he had significant Edge over his peers in terms of military strategy and tactics and was one of the greatest leaders the world has ever known. Alexander's tutor, Aristotle (whose name means "the best purpose") was a Macedonian, whose father was the physician to King Amyntas. He went to Athens to attend Plato's Academy and upon his return was appointed to

the Royal Academy of Macedon and was selected by King Philipp to teach Alexander (interestingly he taught two other Kings, Ptolemy and Cassander). Aristotle clearly studied nearly every discipline from the humanities to the sciences, but perhaps his most lasting achievement is he is considered the first true scientist. As I have always contended that my science education was great training for investing, it makes sense that we can find investing wisdom in Aristotle's work. The picture at the beginning of the letter is from *The School of Athens*, a fresco by Raphael, showing Aristotle and his teacher Plato. Aristotle, on the right, gestures to the earth, representing his belief in knowledge through empirical observation and experience and he is holding a copy of his *Nicomachean Ethics*, his treaty on practical ethics, the idea that you become good, by doing good, not from the knowledge of good. If we study Aristotle's pupil, Alexander, and look at his life and personal philosophy, we can come up with a list of ten Edges that he possessed (along with probably a few others) and if we embrace these Edges, they can make us better investors (and people). Given that Alexander attributes so much of his success to his teacher, Aristotle, we have also assembled a series of his quotes that help us define and describe each Edge.

Mentorship: Having great teachers and mentors in one's life is essential to developing skills, as you benefit from the transfer of knowledge and wisdom from their experience. I have often quoted the line, "look at the four people you spend the most time with, that is who you will become" and making sure that some of these are strong mentors is critical to success. Alexander had Aristotle, which is pretty great, and he said *"It is not once nor twice but times without number that the same ideas make their appearance in the world"* and having people with great experience in your life that have been through the cycles is invaluable. I have been lucky in my life to have some great mentors, like Julian Robertson, and we wrote in last quarter's letter about Julian getting Bearish three times in the past twenty years and that having his perspective on how to respond to something that appeared new to anyone experiencing it for the first time made a big difference. We said *"in each instance, he started off mildly concerned about imbalances that were building and then he became increasingly vocal in his public appearances, as the situation grew increasingly dire. On each occasion he made significant adjustments to his portfolios that ultimately preserved capital and generated superior returns over the course of the entire event and we would all be wiser, and wealthier, had we followed his lead when the Big Tiger turned into a Bear."* The most important thing to me about mentors is they constantly challenge you to think and to be active in considering many perspectives, options and potential solutions to problems we encounter. *"The energy of the mind is the essence of life"* is a great summary of this construct in that always keeping full engagement of the mind is what can lead us toward greatness. Whether we are Alexander the Great facing a legion of soldiers, or investors thinking about how to capitalize on opportunities as they arise, having great teachers in our lives to give us the tools to respond effectively, truly gives us an Edge.

Carpe Diem: When Alexander's father was assassinated, he was only 20 years old, but he seized the opportunity to become King and took full advantage of the opportunity that presented itself, becoming the world's most successful military commander. We do not always know what lies in store for us in the future, but we must always be ready to act when the time comes. In investing, we are continually presented with opportunities that arise from unexpected turns of events and we need to pounce on the best ones in real time. In many cases we will not have time to step back and do extensive study of the situation and we have to rely both on our training and experience, but also on our "gut instinct." That instinct is actually the accumulation of experience we gain in reacting to opportunities over time. So what happens when we don't have lots of experience in something? Then we rely on our teachers, our trusted advisors and our friends to help us. There are a couple of Aristotle quotes that I think are a little bit orthogonal to this construct, but apply nicely to the current situation in Greece (and maybe a few other places) and show how sometimes you are forced to seize the day. The first is *"A common danger unites even the*

bitterest enemies” and this can be best seen in the Tsipras Pivot where it was unthinkable that the far-left Syriza party leader and the center-right coalition members could possibly come together, but when facing the common danger of expulsion from the Euro, Alexis moved right and the right moved left and they may just meet in the middle. The second quote is *“Misfortune shows those who are not really friends”* and in this case, it is abundantly clear that Germany and Greece are not friends. Perhaps I am not the only one that finds it ironic that Germany is the power they are today, in part, because of the kindness of Greece (among others) to forgive the huge German debts after the war (4X GDP, more than twice what Greece has now) and now they won’t give an inch in the debt restructuring discussions.

Vision: Great leaders (and great investors) have great vision. They are clear in their objectives and they maintain focus on the end goal, even during the most challenging times. As Yogi Berra eloquently said, “If you don’t know where you’re going, you’ll end up someplace else.” Aristotle was a bit more eloquent in saying *“First, have a definite, clear, practical ideal; a goal, an objective. Second, have the necessary means to achieve your ends; wisdom, money, materials, and methods. Third, adjust all your means to that end.”* Alexander the Great had a very clear goal. He wanted to rule all of Asia, to create a completely dominant Empire. People want to follow leaders with big goals. Alexander was famous for saying *“There is nothing impossible to him who will try.”* The greatest investors I have known all share that same desire to be the best, to achieve the best returns, to outdistance their rivals by consistently compounding capital over many decades. We actually wrote about this last quarter in saying *“another unique characteristic of Julian (and of all truly great investors, including Soros and Druckenmiller) is when he was convinced that he was “Right”, he would “Bet the Farm” (similar to Soros’ advice to Druck in similar situations to “Be A Pig”).* The other thing about great leaders/investors is they have the courage of their convictions to think independently. As Aristotle said *“To lead an orchestra, you must turn your back on the crowd.”* There are actually two subtle points here. One is that you have to be able to tune out the conventional wisdom (price is a liar again) and ignore mass opinion. We wrote about this challenge last quarter in saying *“it is the actual process of the bubble forming that prevents us from even considering that we might want to take a precautionary stance, because we are seduced by the rising prices of assets (another example of Reflexivity). Just because the rest of the market participants didn’t see the dangers on the horizon that Julian did, and short-term returns were very strong, didn’t mean that we shouldn’t be more cautious (sounds similar to today).”* The second is that you have to be intently focused on the group you are leading, or the opportunity you are evaluating. Finally, Stephen Pressfield wrote a novel of historical fiction, *The Virtues of War*, that tells a first person account of Alexander the Great and there are some great quotes from that book that he developed from studying Alexander’s life. There is a perfect one on Vision; *“When deliberating, think in campaigns and not battles; in wars and not campaigns; in ultimate conquest and not wars.”* Investing is about the long-term and you need to intently focus on the total portfolio, not every position in the portfolio. You don’t have to get every position right, or even every sector right, but you want to stay focused on the ultimate conquest, compounding capital over the long run. The key is to give in on battles where you have no edge (cut your losers) and press your winning positions to advance your campaigns. This quote also applies to Alexis Tsipras’ new Gordian Knot; he has been willing to lose battles, and perhaps even step back from a campaign, as he is intently focused on winning the war and putting Greece back into a position where they can once again think about ultimate conquests.

Leadership: Leaders lead from the front. They set the example of how to think and how to act and inspire people to follow them. Great investors are active, they are constantly making decisions, capitalizing on opportunities and readjusting their strategies to the environment. Alexander was the epitome of this trait as he was always out front, showing the way forward and taking the point. Great leaders and great investors also exhibit uncanny discretion,

as Aristotle said *“Whatever lies within our power to do lies also within our power not to do.”* The ability to determine which strategies will succeed and which will fail, when to press an advantage and when to retreat, is what separates the best from the rest. One of the problems of leadership, of being out front, is the risk of being criticized for trying something new, something bold or something innovative. Aristotle said very clearly that, *“Criticism is something we can avoid easily by saying nothing, doing nothing, and being nothing.”* Great leaders/investors act and, on occasion, they make mistakes and will be criticized. If you fear criticism you won’t act, and if you don’t act, you can’t win. Another quote from *The Virtues of War* is perfect in this regard. Alexander would say *“Nothing is worse than indecision. Be wrong. But be wrong decisively. A horse must be a bit mad to be a good cavalry mount, and its rider must be completely so.”* In battle, and in investing, you can’t afford even a shred of indecision, as troops will not follow indecisive leaders and investment opportunities will not wait for indecisive investors. You will be wrong. Count on it. But, you must be decisive in your actions in order to capture opportunity. The last part of the quote speaks to a common trait of truly great leaders/investors, a touch of madness, a willingness to go decisively into the fray where few are willing to dare, to rely on your training, cunning and instinct to out battle your opponent to win the victory. We wrote about this in *Highway to the Danger Zone*, when saying that great investors had a little bit of fighter pilot in them; they were instinctive. Maverick says to Jester in a mission debrief, “you don’t have time to think up there, if you think, you’re dead.”

Discipline: While great leaders/investors are willing to leap into the breach, to enter into what appears to be an uncertain situation, one thing they are not, is reckless. On the contrary, they are disciplined and will only engage when they believe they have an edge, an advantage, either from knowledge, from position or from resources. Discipline is a way of being, a code or a manner of thought that is embodied by great leaders/investors, which allows them to consistently execute with precision and achieve outstanding results. Aristotle recounts the challenge of discipline when he says, *“I count him braver who overcomes his desires than him who conquers his enemies; for the hardest victory is over self.”* The greatest impediment to discipline is you. Discipline is hard work, really hard work, and it requires commitment, both mental and physical, to achieve true greatness. The great ones have physical, emotional and spiritual balance in their lives, which allows them clarity of thought to react in the optimal way when times are challenging. Oftentimes it appears that great investors are lucky, that fortune smiled upon them. The reality is that luck is simply where preparation (discipline) meets opportunity. When you are prepared, when you have studied the plan, considered all the potential outcomes and set decision rules in advance you are ready to engage, on the battleground, or in the investment arena. Aristotle points out another important aspect of discipline when he says, *“The aim of the wise is not to secure pleasure, but to avoid pain.”* Said another way to apply directly to investing, if you take care of the losses, the gains will take care of themselves. Great investors understand the mathematics of loss (takes 25% gain to overcome a 20% loss) and believe that compounding is the eighth wonder of the world. Alexander the Great was undefeated in battle (no losses) over his lifetime and that is how you amass the greatest Empire the world had known to that time.

Flexibility: Alexander solved the Gordian Knot problem by keeping it simple and thinking differently. He was flexible and didn’t adhere to the standard idea that one must untie the knot. The challenge was to disentangle the knot and his sword was the perfect, albeit alternative, solution. Great investors are constantly thinking of creative ways to capitalize on opportunities, to manage risk and to explore new ideas. They continually refine their strategies and remain flexible in order to respond to changes in the market environment. Soros said, “Markets are constantly in a state of flux” and the truly great returns are made, “by discounting the obvious and betting on the unexpected.” Aristotle made another important point for investing that *“It is the mark of an educated mind to be able to entertain a thought without accepting it.”* We are constantly bombarded with information (even

more so in the computer age) and we must have the ability to process incredible volumes of data and turn it into useful information. We must be able to entertain new ideas, contemplate them, compare them to our core beliefs and then accept or reject them on their merits, not simply agree with everything we are presented with, particularly when those things come from the “experts.” One of the most important axioms in investing is to consider the source, as the world is awash in biased and incorrect information which we must be able to recognize, and reject, in order to excel. Another challenge is that there will come a time when things are not going well and Aristotle reminds us that, ***“It is during our darkest moments that we must focus to see the light.”*** I have often tweeted that Focus = #Edge and the ability to block out the extraneous and clearly envision the solution is what made Alexander great and what allows great investors to prosper. When your strategy is not working, you must be flexible and change. Alexander had three different strategies in his career, Mole, Catapult and Navy, and he was able to take the feedback from the waning strategies and focus on creating new, superior solutions.

Confidence: Legend has it that Alexander was descended from Zeus, so when he announced he was coming, he was always able to “Go Big.” Not many of us have deity roots, so we are starting from a slightly lesser point when it comes to confidence, but the greatest leaders/investors are all supremely confident. They are not arrogant. They are simply confident in their ability to win consistently and they do not contemplate defeat. It is like sports; a positive mental attitude is real edge, if you visualize hitting the ball down the fairway, you are more likely to have that outcome than if you visualize slicing it in the woods. Aristotle says it this way, ***“You will never do anything in this world without courage. It is the greatest quality of the mind next to honor. Courage is the first of human qualities because it is the quality which guarantees the others.”*** When you are confident, when you act courageously, you are more likely to succeed. Alexander rarely had the superior fighting force, he was always fighting on foreign soil and had no home field advantage, yet he was never defeated. Why? Confidence. Alexander never thought he could lose; he never even contemplated that outcome. Investing is the same. When we enter an opportunity with confidence, when we have done the work and taken advantage of all of our strengths and resources, we will win. When we enter an investment in a fearful, tentative fashion, chances are we will lose money. On the other side of this point, Aristotle said, ***“He who has overcome his fears will truly be free.”*** In investing this refers to the fact that the best opportunities are the ones that make you the most uncomfortable. They actually make you feel a little sick to your stomach. When you are able to overcome that discomfort, you will make the greatest returns. Pressfield wrote, and Alexander might have said, ***“Always attack. Even in defense, attack. The attacking arm possesses the initiative and thus commands the action. To attack makes men brave; to defend makes them timorous.”*** Investing is about attacking and it is about being confident. When you are timid, when you play not to lose, that is exactly what you do. Once again, attacking is not reckless; it is well-reasoned, well-planned, well-rehearsed and well-executed, but it is also aggressive, active and brave. Bravery wins.

Self-Awareness: We all have strengths and we all have weaknesses. Self-knowledge of what they are, on both sides, is critical to success in any endeavor. Pressing your advantages and bolstering your weaknesses is the surest way to move toward greatness. Aristotle commented on the importance of taking time to do self-appraisal in saying, ***“The ultimate value of life depends upon awareness and the power of contemplation rather than upon mere survival.”*** If we are able to spend time in deep contemplation, we can enhance our quality of life and have greater success. In investing, the ability to withdraw from the “survival” mode, from the daily barrage of information and distraction, and spend quality time away in reflection and contemplation will allow us to discern where the best opportunities exist and how to best attack them. That said, no matter how effective we are at appraising opportunities and making decisions based on our strengths and avoiding our weaknesses, we will inevitably make mistakes. Aristotle said that, ***“Learning is not child's play. We cannot learn without pain.”*** In

investing, we will experience pain, the pain of loss (of bad decisions), the pain of regret (of missed opportunities) and the pain of inaction. The key is to learn from those mistakes and get better. One of my favorite lines in investing is that “being wrong happens,” but “staying wrong is stupid.” We must have the self-awareness, the self-discipline and self-confidence to admit when we are wrong, take lessons away from the experience, make adjustments and attack the next opportunity. One of my favorite manager friends has a great line, “with every investment, we get richer, or wiser, never both.” The point being that when we are successful we don't spend the time to think about what went right and learn from it, but when we make a mistake, we are a little poorer, but we spend an amazing amount of time analyzing what happened. We wrote last quarter about a trait of the very best investors saying *“another characteristic of truly great investors is that they don't make the same mistake twice. All investors make mistakes (even the great ones), but what separates the great ones from the rest is the ability to learn from those mistakes and change their behavior in the future.”* The problem for the rest of us is there seems to be an endless supply of mistakes to make the first time...

Gratitude: We are all given many gifts and for those we should be grateful. For those of us blessed to be in the position to make investments, we should be even more grateful. Alexander was also keen on the concept of not taking life for granted as you never know how much time you have (he actually died at a rather young age of 32) and that construct has become more important to me this year as I have lost three close friends at far too young an age. This goes back a little bit to Carpe Diem above, but there is more. Aristotle said that, *“The greatest virtues are those that are most useful to other persons”* and we should always keep this in mind that servant leadership is what we should strive for in life. In investing, we should keep in mind the ultimate beneficiary of our work, helping families meet their spending needs, funding scholarships and professorships, making grants or helping to promote other philanthropy. We have a saying at the Creek, “if you continually give, you will continually have” and we believe strongly in developing the virtues that are of most benefit to others. Aristotle also said that, *“Pleasure in the job puts perfection in the work.”* Someone once said that, “if you do what you love you will never work a day in your life.” We believe that wholeheartedly at the Creek and I think all the great investors I have ever known receive immense pleasure from their job and that actually makes them more effective investors.

Character: The old adage is that character is what you do when you don't think anyone is watching. When I asked Julian Robertson years ago what made a great investor, he talked about intellect, collaborative skills and competitiveness, but he overemphasized integrity. Leaders must inspire trustworthiness or their followers won't follow and investing with people who lack integrity has been a recipe for losing money since the dawn of time. Aristotle had an interesting view on this point in that he did not believe you could simply have knowledge of what is right, you actually had to live what is right. He said very directly that, *“Men acquire a particular quality by constantly acting a particular way. You become just by performing just actions, temperate by performing temperate actions, brave by performing brave actions.”* It is the same in investing. You become a better investor by investing. You can't just talk about investing, you can't theorize about investing, you have to put real capital (most importantly your own) at risk and experience the pain of loss and the thrill of victory. The real problem with most things in life is it takes a long time to gain experience and it is the accumulation of experience that allows us to develop the character traits or investment acumen. Aristotle has an interesting line related to lack of experience when he says that, *“youth is easily deceived because it is quick to hope.”* Youth, or the inexperienced, don't have the perspective to understand all the potential outcomes of a complex situation, whether in battle or in investing, so they are hopeful that the outcome will be what they desire. I have said many times that “hope is not an investment strategy; it is a four letter word.” Just because you want something doesn't mean you will get it. For example, a lot of pension funds hope that they will achieve their actuarially assumed rate of return

(around 7.5% today) over the next decade, but with interest rates at 2% (we know that will be the return on bonds) and equities expected to barely break even (latest GMO forecasts), there is literally no hope that a traditional 60/40 portfolio will achieve that return. Another Gordian Knot dilemma that is in need of a swift Alexander blade solution to unloose the strategy and find an alternative solution.

Legacy: To leave the world a little better place than you found it should be a goal for all of us. To be excellent in our field, to set an example for those that follow and a standard for others to achieve should be a lofty ambition. In the end, we all want to be memorable, to leave a legacy. Aristotle had advice on this ambition in saying *“Excellence is never an accident. It is always the result of high intention, sincere effort and intelligent execution. Excellence represents the wise choice of many alternatives. Choice, not chance, determines your destiny.”* In essence, we chose the legacy we want to leave by the choices we make in our lives. He went further in saying *“Excellence is an art won by training and habituation. We do not act rightly because we have virtue or excellence, but we rather have those because we have acted rightly. We are what we repeatedly do. Excellence, then, is not an act but a habit.”* We are what we repeatedly do. Words to live by. We are made better by deliberate practice, the performance of well-coached, disciplined practice, to groove an Edge that we can repeat again and again. Malcolm Gladwell talked about the 10,000 hours, the amount of time it takes to master something, to become truly excellent. If you follow Alexander’s example and hone these ten Edges, then we have a chance at Greatness and the chance to leave an enduring legacy. Alexander gets the last word. He said, *“I assure you I had rather excel others in the knowledge of what is excellent, than in the extent of my power and dominion.”* Be Excellent.

Intractable problems. Bold solutions. These are the things we are faced with, and the things we are in need of, in today’s complex investment environment. Greece’s new Gordian Knot is just one of the challenges that global investors must solve in order to be successful. Slowing economic growth, demographic headwinds and massive debt problems in the developed world, paired with unstable currencies, political dysfunction and fragile economies in the developing world, combine to create both challenges and opportunities. We will need all of the Edges of Alexander and all of the wisdom of Aristotle to navigate these treacherous seas in the quarters and years ahead.

SECOND QUARTER REVIEW

The intra-quarter cyclical pattern in the U.S. equity markets that had persisted for nearly two years finally broke down in the second quarter of 2015. We described the phenomenon for the first time in the Q2 2014 letter as follows: *“there has been a very interesting pattern in each of the past four quarters, that equity markets fall for the first two to four weeks of the period and then turn sharply upwards when the Central Doctors (Bankers) agree to provide another hit of Monetary Morphine.”* There was no weakness in April to begin the quarter this year and given that the QE baton has been handed to the Bank of Japan (BOJ) and the European Central Bank (ECB), there was little chance of a surprise from the Fed to push markets higher. The end result was a meandering market that finished just about where it began (from 2067 to 2063 on the S&P 500) with very little volatility. The S&P 500 Index posted a 0.3% Q2 return including dividends, bringing CYTD returns to a very unimpressive 1.2%. We have discussed on numerous occasions in previous letters how there has been an interesting correlation between the QE bond purchases in the U.S. and subsequent increases in the S&P 500 and commented that, *“historically every \$100 billion of QE has translated into 40 S&P 500 points (calculated by Larry Jeddelloh at TIS).”* We went further in our Q4 letter from last year and asked an important question: *“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?”* Put another way, what would happen *“if the patient was forced to look at the MRI (valuation measures) without the soothing effect of the monetary morphine.”* With no anesthetic, the reality of market valuations in the U.S. is quite harsh as every valuation indicator including Yield, P/B, Market Cap/GDP, CAPE Ratio, Tobin’s Q and standard P/E Ratio of the S&P 500 are currently at levels exceeded only by the ridiculous levels of the Tech Bubble. With no QE to boost liquidity and the reality of falling earnings thanks to currency losses from the strong Dollar and revenue declines due to

collapsing global growth, the larger question is, again, how would equities continue to rise? Given the meager performance in Q2 and CYTD and the fact that nearly all of the 1.2% return is due to dividends, we have our answer; it appears that they won’t. To this point, we wrote in January in our MCCM Ten Surprises list (#4, Here’s to you Mr. Kindleberger) that contrary to all the positive market trend data, 2015 would turn out to be the first negative year for the S&P 500 since 2008.

With the QE baton firmly in the hands of the ECB, the early quarter market malaise pattern hit the EuroStoxx 50 Index which fell (4%) for the first four weeks of the quarter, but this time there was no relief rally (despite Super Mario’s continued bond purchases) as fears related to the “Greek Crisis” put continued pressure on European stocks and they fell another (3%) to finish down (7%). The continued ECB QE put additional pressure on the Euro, however (which shed another (5%) during the quarter), and for investors who hedged the currency losses were a more modest (2.2%). Interestingly, we wrote in this section last quarter that given the huge 17.5% rally in European equities in Q1 that *“it would make sense to see a pause that refreshes in the short-term in Europe, but the infamous admonition of “Don’t fight the Fed” can clearly be modified here to “Don’t fight the ECB” in the coming year.”* We also noted last quarter that there could be a similar relationship between European equity markets and the ECB QE activities that we had observed in the U.S. markets, but that we needed to try and quantify the exact relationship. With four months behind us, the European Central Banks have purchased \$240B of bonds and the EuroStoxx 50 Index has rallied 280 points. If we extrapolate an essentially 1:1 ratio for the balance of the year, we might expect to see the Index rally another 360 points, or precisely 10% from its current level of 3600.

In the other developed market that has a firm grip on the QE baton, Japan (otherwise known as the Land of the Rising Stocks), the equity markets had another

strong quarter, rising 3.1%, to take an even more pronounced lead at the midpoint of 2015, with the MSCI Japan Index up 13.6%. We wrote last quarter that, *“the implementation of Abenomics has finally removed the specter of deflation after two long decades and has led to a virtuous cycle of rising inflation expectations, rising earnings and rising asset prices.”* The biggest contributor to the continued move in Japanese equities has been the strong earnings growth within Japan Inc. and Q2 was a particularly good quarter for the banks, which finally surged past the balance of the Nikkei after lagging most of last year. We had written about the banks in the last few letters and said last quarter that *“the one area of frustration within the Japanese market over the past couple of quarters had been the banks which we believed were extremely cheap and should have been benefitting from the lower Yen as well.”* The banks finally got the memo and SMFG, MTU and MFG finally showed the promise we began to write about in Q4 of last year as they jumped an impressive 14%, 14% and 22%, respectively (to bring CYTD returns to an even more impressive 27%, 34% and 34%, respectively). Perhaps the most interesting thing about the most recent move in Japan has been that it has occurred without any Yen depreciation tailwind. BOJ Governor Kuroda-san has been noticeably absent from the markets and while the Yen did meander down (2%) during the quarter, interestingly, the unhedged (NKY) and hedged (DXJ) return for Japanese equities in 2015 is roughly the same, around 14%. We wrote last quarter that, *“we think the party is just getting started in Japan and that there are more significant gains ahead. MCCM Surprise #9 says that Japan has No Way Out other than to weaken the Yen and drive up asset prices. There will be some resistance along the way, but the Yen could reach 140 by year-end (from 120 today) and the Nikkei could hit 22,000 (from 19,500 today, up from 17,500 when we wrote the Surprise).”* At the halfway point those predictions look achievable with the Yen at 123 and the Nikkei at 20,236.

Going back and taking a closer look at the

performance of the U.S. equity markets in Q2, despite the lackluster results of the overall market as measured by the S&P 500 Index, there were pockets that exhibited more Bull Market-like characteristics (to keep hope alive for the Bullish crowd). In the U.S., both Mega-cap and Micro-cap stocks outperformed the index, up 0.9% and 2.8%, respectively, and the tech-heavy NASDAQ more than quintupled the S&P 500, rising 1.8%. One other Bullish segment of the markets in 2015 has been Small-cap growth as the R2000G has dominated the R2000V, surging 9.2% versus 0.8% (over the TTM, that gap widens to 11.6%). The best performing sectors in the S&P 500 were quite disparate in the quarter as Healthcare continued to dominate, rising another 3.6% (to be up 8% CYTD) and Consumer Discretionary also surged, rising 2% (to get to a very solid 6.5% CYTD). Maybe some of those savings from lower gas prices are finally being spent. Interestingly, when we add July to the mix, these two sectors are neck in neck, up 12%, well ahead of any other sector and about 4X the S&P 500. Getting back to Q2, the rest of the sectors in the S&P were pounded for the most part, with Materials down (1%), Staples and Industrials both down (2.5%), Energy down (3%) and Utilities down another (6.8%). All things yield oriented got hit hard in Q2 (more on those trends below in fixed income and yield sections) and XLU was down (13%) at the end of June (but has rallied hard in July and is only down (7%) now...). Taken together, all the data in the U.S. sums to a profile of a very tired Bull Market with the more defensive sectors like Healthcare and Consumer Staples leading and the commodity related sectors like Industrials and Materials lagging.

The U.S. Dollar took a breather in Q2 (after the parabolic 9% surge in Q1) and fell (2.5%). Foreign equity markets had been getting punished by the surge in King Dollar, but international markets performed relatively well in Q2 and there were even a few big winners. We have said in the last couple of letters that, *“getting the Dollar right in 2015 may be one the most important portfolio decisions an investor can make”* and we continue to believe that to

be the case. If we look at the broad international indices during the period, the ACWI ex U.S. rose 0.5%, EAFE was up 0.6%, MSCI Europe was up 0.4%, MSCI Japan rose 3.1% and the MSCI EM Index rose 0.7%. One surprise was that the MSCI EM Small-cap Index jumped a robust 4.5% to be up a very strong 8.3% for the CYTD. For the first half of 2015, it has been a good year to invest abroad as all of the major global indices are up more than the S&P 500, with ACWI ex US up 4%, EAFE up 5.5% and MSCI EM up 3%. Diving deeper into the individual markets, some of the strong returns were very strong, particularly in the PIIGS and EM. Portugal was up 2%, Italy was up 2.5%, Ireland surged 8.5% (to be up a very surprising 12.4% CYTD on the back of a huge recovery in GDP growth), Greece rose 5.2% (on hopes of a third Bail Out, which did materialize, but not until after the Troika forced the banks into capital controls which will hurt Q3 returns) and only Spain lagged, falling (2%). One other point we made last quarter was that *“there will continue to be wide dispersion in the region and there will be both winners and losers as the ECB plan plays out, so we would expect to find some very attractive investment opportunities on the Continent in the coming quarters on both the long and the short side.”* That has indeed been the case and our European focused managers are putting up strong numbers this year (up between 10% and 12%). While the EM Index return was muted, some of the individual markets were quite strong with China up 6% (before having a very rough July, down (10.8%) despite government intervention to stem the declines), Brazil jumped 7%, Russia surged 7.6% and India was one of the few laggards, falling (3.6%). Much of that strong performance in EM has been reversed in recent weeks and we will write more on that next quarter, but the short version here is that fears of the Fed raising rates has continued to plague EM currencies and rising concerns about slowing global growth have triggered another flight of capital away from EM. We just did our Around the World Webinar titled *Build Your House With BRICS: Why Emerging Markets Rule* and we can't help but hear Sir John'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.

We discussed the details of our controversial EM call from the MCCM Surprises in the letter last quarter. We highlighted that Surprise #7, *Water Finds Its Level*, was quite a contrarian a call and said *“given the cacophony of bad news around EM growth, currency woes in the face of King Dollar and the dismal results in EM and FM markets in Q4 (and 2014 as a whole)”* being positive on EM coming into 2015 was truly a Variant Perception. We also discussed the segmentation of EM into the Service (Current Account surplus) economies and Commodity (Current Account deficit) economies and discussed how the rapid decline in oil prices would create tailwinds for the former and headwinds for the latter. Looking at the performance for Q2, there was less distinction between the Service and Commodity countries. Some of the Commodity countries ignored the Current Account issue and continued the surge that began in April as Brazil, Russia and UAE surged 7% to 11% while others like Mexico, Turkey and Qatar were basically flat for the period. One Commodity EM we had been excited about was Russia (in fact, it was another of our MCCM Surprises, see #5 below) as we believed extremely low market valuations would mitigate some of the oil price correlation risk. Russian equity returns were very strong following the Central Bank emergency interest rate hike last December with Lukoil, Gazprom, Sberbank, VIP and RSX up 35% to 60% as the RUBUSD surged 38%. However, as oil prices rolled over in June and July, the Ruble gave up much of those gains and the Russian names are now up *“only”* 5%, 1%, 21%, 35% and 15%, respectively. With the temporary recovery in oil prices in Q2 (WTI ran from \$44 to \$60 in the first half of the quarter), the Services Countries suffered from fears of rising energy costs. The only solid performance came from China, which rallied 6% (then the China markets peaked and fell hard in July), but India dropped (3.6%), Korea fell

(3.7%) and Indonesia was pummeled, shedding (14.1%). We have liked India since right before Modi became PM and were surprised by the lack of performance in the past year. We wrote last quarter that *“while the short-term results have been disappointing, we see outstanding growth ahead and will continue to build positions in companies like Tata Motors, ICICI Bank, Sun Pharma (IN:524715) and Dr. Reddys (IN:500124).”* While the India Index has done well in the past three months (INDA up 5% versus S&P 500 flat), the volatility of individual names has been very high as the India basket above had returns of down (27%), (6%) and (13%) and up 24%. With oil prices collapsing again in July (back to the mid-\$40s) the Services oriented markets should resume their climb in the second half and we could see some solid gains across these markets in coming quarters.

Frontier markets had a similar quarter to India in that the Index performance was muted (MSCI FM Index was flat), but the volatility across individual markets was fairly extreme. A few representative samples exhibit the trend as Nigeria rose 4.9%, Saudi Arabia was up 5.3% and Ukraine was up a spectacular 17.4% (on the back of the Central Bank emergency interest rate increase), while Kenya was down (10.9%) and Argentina shed (13.6%). Saudi has been a favorite market where we thought investors were missing the emerging consumer story and we discussed last quarter another benefit was the inclusion of Saudi Arabia in the Index as *“MSCI has announced that they will make the Index move in June, so we expect the Saudi markets to continue to be very strong.”* The Saudi market has indeed been solid all year (in anticipation of the move) finishing up 11.9% for the first half of 2015. The performance in the two Africa markets reflects short-term implications of higher energy prices in the quarter as the Commodity country (Nigeria) benefitted and the Service country (Kenya) gave back recent gains. Ukraine had been in free fall thanks to the continued conflict with Russia, but the dramatic measures taken by the Central Bank to stave off default led to a dramatic increase in

inflation, which filtered down into equities. Argentina has been one of our favorite markets since early 2014 (right after the devaluation) and we wrote last quarter that *“with the election now in plain sight (October) investors are cheering the departure of Crazy Cristina sending BMA up 34%, PAM up 53%, and YPF up 30%. We expect that once the hedge fund holdout issue is settled (likely in May/June as a political move to win votes for the Peronista candidate) that Argentina will be a great place to make money as the capital markets open and corporate profits rise.”* Unfortunately, the holdout issue was not resolved and speculation is that now it will not be settled until after the election, so there was some clear disappointment in the Argentinian equity markets (hence the sharp correction). The selection of a very pro-Cristina candidate to be Scioli’s running mate also weighed on markets, as global investors believe Macri would be more pro-business, but are concerned that Scioli is leading in the polls. In the end, anyone will be better than Cristina, we will get the holdout issue behind us and we continue to see tremendous opportunity in Argentina, believing it will be one of the best performing markets over the coming year.

Going back to China, we continue to see positive signs of a transition in the economy from fixed asset investment toward consumption and we expect that the commitment of the Chinese leadership to promote more of an equity ownership culture will lead to a long-term Bull Market in Shanghai over the coming years (see Surprise #10 below). That said, the volatility in the Chinese equity market over the past few months has been extreme and it appears that the exuberance of investors hit an unhealthy level that required some correction. We wrote last quarter that *“there has been an explosion of pundits calling the recent move in Chinese equities a Bubble and not a day goes by without a discussion of the impending crash (comparing the current surge to 2007). In 2006 and the first ten months of 2007, the Shanghai Composite index rose 440% and then subsequently crashed (70%) over the next twelve months as the Global Financial Crisis struck.”* With an asymptotic

move in the A-Share market in the first half of Q2 and with some sectors in the ChiNext and Shenzhen exchanges reaching silly valuation levels, it appears that some of those concerns were warranted. However, we also wrote last quarter that *“the overall Chinese equity market is actually near the bottom (not the top like the S&P 500) of its multi-decade trend channel (shown in a great chart by Chris Kimble that we found on Twitter at @kimblecharting)”* and with the move down in the second half of the quarter, overall valuations are again pretty cheap (the CSI300 Index of A-Shares is back to 12X forward EPS). The China Skeptics are out in force these days with overlay graphs of the Shanghai Index compared to the DJIA in 1929. There clearly has been a meaningful pullback in prices in the last few weeks, but the China markets were up 6% in Q2 and the SHCOMP remains up 10% CYTD, so long-term investors who have been invested for a while are doing just fine. We quote Sir John Templeton again, “Bull Markets grow on Skepticism,” so there is plenty of fuel for the China markets to continue their upward march.

Fixed income markets have been surprisingly volatile in 2015 as the continued uncertainty about when the Fed will raise interest rates wrecked havoc on bond investors. The Bond Bulls had their way in Q1 as the Barclays Aggregate rose 1.6% and the Barclays Long Treasury Index was up 4%, but the Bond Bears took control in Q2 as the Aggregate Index gave back all the Q1 gains, dropping (1.7%) and the Long Bond Index dropped an astonishing (8.3%) to push CYTD returns to a very unattractive (4.7%). The pain in the bond markets came despite the fact that U.S. economic data continued to come in weaker than expected and inflation (the real driver of long-term bond returns) was collapsing. We wrote last quarter that *“the theory that we have heard is that the huge decline in GDP from and estimated 3% just six short months ago (and a consensus of 1% on the release date) was so bad that the Fed may as well go ahead and raise interest rates because “how much harm could she do at this point?”* We reiterate here that we will take the over on how much harm will be inflicted on the economy, and the

financial markets, if Ms. Yellen decides to tighten liquidity in an economic environment looking more and more recessionary. Our view in the MCCM Surprises was that the Fed would confound all the pundits this year and not raise rates, as economic growth would not rebound enough to support higher rates (Ms. Yellen has been sending her Minions out this past week to say for sure she will nudge rates in September to see what the market reaction will be). The Bond Bears have been putting up Mission Accomplished banners everywhere despite the fact that since 1990 there have been nine meaningful back-ups in interest rates (where the Bears declared the Bond Bull market over) with an average of 127 bps of increase. The current rise in rates is actually the smallest of the nine moves at around 60 bps. The challenge for the Bear story is that the real interest rate (nominal rate minus inflation) is the same 3% today as it was in 1990 and the secular low in Treasury yields is unlikely to occur until the real rate is significantly below the long-term average.

In the other fixed income markets Q2 was a far less hospitable environment than Q1 as everything from global bonds, to high yield and emerging markets debt was clipped. The Barclays Global Bond Index was down (1.7%), The BoAML High Yield Index was flat (0.05%) and the JPM EM Debt Index slipped (0.3%) as investors who had desperately stretched for yield found out that life way out on the risk curve was not as much fun as they had anticipated. It is tough to make good long-term returns when the risk/reward environment is such that you can lose an entire year of coupon income in three months. Government bonds around the globe had become the asset of choice for most over the last year as investors piled in to these securities to try and front run the ECB’s plan to begin a QE Program for Europe in January. As we discussed last quarter, *“the wall of liquidity into these markets should have raised prices and produced solid returns for investors. However, for U.S. based Investors, the almighty King Dollar created a huge drag on performance and the Barclays Global Bond Index fell (2%) in Q1, a disappointing outcome given*

the dramatic fall in interest rates around the world. In Q2, the King Dollar went on Holiday and the “Bond Kings” (Gross & Gundlach) took center stage as they began “talking their book,” saying that short European Government Bonds was the “trade of a lifetime.” Like the old E.F. Hutton days (when he spoke, people listened...) everyone tried to sell at once and given how liquidity had evaporated in the Bond markets (thanks to the all the new Bank regulation post-GFC) it was not a pretty picture (like shouting fire in a crowded theatre). Unfortunately, those who thought bonds were a safe haven once again learned the hard way about the Howard Marks quote, “there is no asset good enough that you can’t mess up by paying too high a price.” We wrote how it didn’t make sense to us to buy German Bunds at prices that produced a 7 bp (not a typo, no zero missing) yield for 10 years and it turns out that isn’t a good idea after all. After being the darling of fixed income investors quarter after quarter, Emerging Market Debt suddenly became a pariah as investors perceived that growth rates in these markets would fall and companies would be more challenged to support their debt. Concurrently, concerns about EM currencies (justified) created a wave of selling in local currency bonds as that index shed (1%).

One segment of the high yield market that we discussed the last two quarters was the Energy sector. After being torched in Q4, energy debt was the darling of the first quarter, as the Pavlovian investor reaction of BTD (buy the dip) seemed to work yet again. To review, we wrote in January that *“there is a lot of concern that some large percentage of the massive \$550 billion of debt issued by energy companies during the Shale Boom will default as oil prices have halved, but we expect that only a small percentage of issuers will go bust as many operators have done a good job hedging production and have bought themselves time to cut costs and restructure. One segment that is particularly vulnerable are the energy services companies as the E&P company cuts in cap-ex are a cost reduction, but are a revenue reduction for service companies. We expect to see*

some tremendous opportunities to buy fantastic assets at fire-sale prices in the coming months.” Back then we thought we had time to wade into this space. But when oil began to recover in March, the banks decided not to withdraw credit from the worst energy borrowers at the April LOC reset and many companies that should have defaulted got a free pass (until October) and their bonds (and stocks) surged. We discussed last quarter how the banks were slow to enforce lending covenants because they would have to realize losses on those loans, so they chose to “Extend & Pretend” (just like they did with RE borrowers after the Global Financial Crisis). We wrote that *“time will tell if energy prices can hold their recent gains and if these overleveraged E&P companies can ever generate enough free cash flow to pay back the banks. Again, we will take the under, but you don’t want to bet against the short-term momentum created by the ostrich approach to loan management.”* As we write the letter today, oil prices have collapsed back to the March lows and these high yield bonds are collapsing right along with commodity prices. The cash flow analysis is not pretty for many of these companies and having just spent some time with one of the best oil traders in the world (on my recent trip to London) who thinks oil prices are going MUCH lower (approaching \$30), we finally may get our fire sale prices on these bonds which bodes ill for HY Index returns in the rest of 2015.

Unlike the last couple of quarters where there was some divergence in yield assets (some good, some bad), Q2 was simply ugly all around. Like a light switch had been suddenly thrown on, investors who had rushed to buy REITs, no matter how high the price rose or how low the cap rates had fallen (both seemed to be at irrational levels), suddenly sold with reckless abandon, pushing the S&P REIT Index down (10.4%) which took CYTD returns to down (6.1%) and nearly wiped out the TTM return (now only 4%). We wrote last quarter that *“we all learned in school that a solid long-term investment strategy is one predicated on selling assets at premium prices and buying assets as bargain basement prices, but in Q1*

investors decided to ignore that seemingly sensible advice, yet again,” but gravity returned in Q2 with a vengeance, as the consensus shifted to a rising rates environment. The volatility in asset classes not supported by QE has become almost unbearable as the short-term moves have completely disassociated from fundamentals and massive capital flows are occurring at lightning speed. Most investors can't be tactical enough to capitalize on these types of wild gyrations, so being more disciplined in rebalancing (selling leading asset classes and buying lagging asset classes) will be critical to effectively compounding capital in diversified portfolios. As bad as the quarter was for REITs it has been the MLPs that have really taken a beating over the past year as these once invincible investments have suddenly become untouchable for most investors. The Alerian MLP Index fell another (6.1%) in Q2, which is bad, but not terrible, when you tack it to the (5.2%) loss in Q1 and the truly ugly (12.3%) decline in Q4, you get a TTM return of (19.8%), coming in at the very bottom of traditional asset returns for the past year. In the give credit where credit is due category, we have to give a shout out to a friend of MCCM, Josh Ayers, (was with a hedge fund we used to invest with and now runs a research and consulting business in Dallas) who nailed this call (albeit a few quarters early). I was visiting with Josh last year and he was thinking about raising a small pool of capital to go short MLPs. We liked the idea and thought his thesis was very compelling, but as we talked over a couple of months the sector just kept rising and the diligence checks we did with our other energy managers said that the MLP operators were protected by the hedging that underlying production companies had done and strong contracts. What we all saw was that the magnitude of the drop in oil and the subsequent drop in rig count would eventually lead to lower volumes and renegotiations of contracts. What Josh got right (and we missed) was that markets wouldn't wait for the actual declines to occur before selling and then there was an added catalyst of the fear of rising rates to prompt the yield oriented buyers to sell too. With these types of corrections, we once again see that it is

okay to be a couple hours early, but not a minute late.

With the perfect segue from MLPs to the Commodity space, Q2 was very confusing as some areas showed some resilience and others continued their steady march downward. With King Dollar on holiday, some of the financial downward pressure on prices was briefly eliminated. As we have discussed above, Oil made quite an extraordinary recovery and rose 25%, reversing last quarter's (15%) drop and bringing CYTD returns solidly into positive territory at 12%. The damage from the mid-June 2014 peak of \$107.26 is still quite extreme with prices hovering around \$60 the TTM return is an unattractive (44%). In thinking about the oil market in 2015, it makes sense to revisit again our Q4 commentary when we wrote that *“there have been lots of pundits, media personalities and oil executives calling a bottom in oil since the mid-70s (quite unsuccessfully obviously as we sit at \$48...) and there is unanimity in the investment community that there will be a sharp bounce in oil prices this year. The logic is that every oil price drop since 1995 has been followed by a sharp rebound, but the flaw in the logic is that all of those declines were demand driven (economic growth slowing leading to less consumption) and we have to go all the way back to 1985 to see what happened during the last supply shock.”* We discussed last quarter how the *“ferocious rally”* in oil from \$44 to \$60 had caught us a little off guard, but also said that *“the oil bulls may have gotten a little ahead of themselves and that moves of this magnitude are actually quite common in Bear Markets as big short covering rallies are precipitated by the perception of good news only to have fundamentals continue to be weak in the future.”* We have built our case for lower oil prices on the construct that this correction is a Supply shock, not a Demand shock, and that prices tend to stay down much longer in the former and recover much more sharply in the latter. Given what we see from our managers and from experts in the industry, we would expect to see continued price weakness into 2016. We will reiterate what we said last quarter, that *“we will stick with our MCCM Surprise #5 forecast of oil*

staying in the \$40 to \$50 range much longer than the markets anticipate, but we reserve the right to change our minds if the facts change, like if the export ban is lifted or GDP growth surprises to the upside.” Interestingly, the facts did change in two ways during the quarter, Demand data was revised downward by the EIA and an Iran Deal came closer to reality which could push the Supply problem to even greater levels, both of which call for oil to stay #Lower4Longer.

There are other commodities besides oil and all of them have been taken to the woodshed lately. Natural Gas has been looking like it has been making a base as returns were muted at 7.1%. While the peak to trough loss since last year is a scary (37%), the threat of a monster El Niño event that could cause above average temperatures has seemingly put a little floor under Natural Gas. Record U.S. production levels are not helping the Bull case, nor is the unwillingness of the banks to force the overleveraged companies to pay up (or shut down), so prices are likely to stay range-bound for a while. Precious metals have been anything but precious to investors in the past few years as Gold and Silver continued their water torture drop in Q2, falling (0.9%) and (5.5%), respectively. Industrial metals were weak, and Dr. Copper fell (4.6%) and aluminum fell (5.3%). We did an *Around the World Webinar* on The Four Horsemen of the #Growthpocalypse and noted that there were four indicators of a looming U.S. Recession: Copper, 10-year Treasury rates, the KOSPI Index (Korea, full of tech component makers) and Oil. Historically, Dr. Copper has been one of the best indicators of the health of the economy and with the massive decline since 2011 (from \$464 to \$240 today) and recent acceleration of the down turn, things aren't looking too bright on the growth front. We wrote last quarter that *“one glimmer of good news is that most of the Q1 loss occurred in during a free fall in January when prices troughed at \$245, so they have staged quite a nice 20% rally off the bottom. The problem is that copper prices have made a series of lower highs and lower lows over the past four years, so we need to see a sustained breakout above \$300 (and probably a move*

back above \$340) before the Doctor’s prognosis is positive.” So far, there are no signs of such a sustained rally and with new warnings about China’s flagging growth, Dr. Copper may be in the infirmary for a while longer. After a really tough Q1 for the Ags where Wheat, Soybeans and Corn fell (13.2%), (5.4%) and (7.2%), respectively, Q2 was a complete reversal as the grains soared 20.3%, 6.6% and 12.2%, respectively. Just to keep things interesting, the grains have reversed again in July and have given back much of those gains, but we will leave that story to next quarter. We have discussed the linkage between Dollar strength and commodity weakness for many quarters and the emergence of King Dollar has supported the end of the Commodity Supercycle headlines that have become so common. One thing to keep an eye on in the coming months is the interesting pattern that the big moves up in the Dollar occur in advance of (in anticipation) the actual raising of interest rates by the Fed. It will be very interesting to see if the pattern persists should Ms. Yellen actually pull the trigger in September and if the fierce headwind for commodities were to subside.

We wrote last quarter that in Q1 *“the stars aligned for hedged investing in the early part of 2015”* and hedge funds broke a long streak of underperformance relative to long-only equities as they battled the headwinds of broken deals, zero interest rates and relentless short squeezes. In Q2, the headwinds were back and it was a tough slog for alternative strategies. In the long/short equity space, the rally in the junky part of the capitalization spectrum and the lack of movement in large-cap equities limited returns in the HFRX Equity Hedged Index to 0.2%. Things were actually a little worse in the M&A arena as the HFRX Event Driven Index ran in place all quarter and finished flat, while the Relative Value sub-Index eked out a small 0.2% advance to match the long/short crowd. Volatility in commodity markets was rather extreme during the quarter and that was bad news for the trend followers, resulting in the HFRX Macro/CTA Index posting a disappointing (4.6%) return, but it was the Systematic CTA Sub-Index that got really

pounded, falling (7.3%). We noted last quarter that it is important to keep in mind *“as a reminder, there are a number of large, successful funds that don’t report to HFR and thus sometimes the returns of the indices can seem out of synch with anecdotal evidence in the markets, which was true again in Q1 as a number of large CTAs produced double digit returns for the quarter.”* There were notable examples of this phenomenon in Q2 as well, particularly in a few cases where funds made levered, directional bets on oil prices rising (that quickly reversed in July, but they got to celebrate in June). The ZIRP environment continues to beat up market neutral managers and the HFRX Market Neutral Index fell another (0.8%). The broader, HFRX Absolute Return Index managed a slight positive return of 0.3% as some of the credit strategies and multi-strategy groups managed to produce modestly better returns. Importantly, despite the low absolute returns, hedged strategies materially outpaced Bonds again as the Barclays Aggregate shed (1.7%). To that point, we continue to see very significant benefits in shifting from Fixed Income toward Absolute Return strategies in diversified portfolios (given their positive correlation to interest rates) in an environment where even the hint of a threat (let alone the actual event) of rising rates has shown the ability to wipe out a year’s worth of coupon income on fixed income land very quickly. Additionally, 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).

The second quarter of 2015 was much like the first as traditional markets in the U.S. produced below average returns (stocks 0.3% and bonds (1.7%)) due to increasing volatility triggered by rising uncertainty about GDP growth, corporate profits and Central Bank decisions. There weren’t many ways to win in Q2, particularly in the U.S., aside from traveling into

microcap equities or finding managers who were strong on the short side. Q2 was hospitable to U.S. investors who traveled overseas as Japan, some of peripheral Europe and a few Emerging Markets performed much better than the U.S. (Japan up 3.1%, Italy up 2.5% and China up 6%). Not all islands were friendly though as there were some places where growth fears, currency woes, or political uncertainty caused some serious nausea (Germany down (5.6%), Indonesia down (14.1%) and Argentina down (13.6%)). We asked an important question last quarter saying, *“how many investors had more Japan and China equity exposure than U.S. equity exposure over the past year? The answer is not many despite the fact that Japan is up 3X the U.S. and China is up nearly 9X (13% vs. 40% vs. 120%, respectively) over the trailing twelve months.”* We believe that being willing to venture outside your comfort zone will be a key to earning superior returns in the coming years as it appears that the trade winds are shifting and navigating with the traditional approach to portfolio management is unlikely to produce the desired (or needed) results.

The performance at Morgan Creek was solid in Q2 as our Long/Short Hybrid Fund again performed very well, our Developing Markets Hybrid Fund again beat the EM indices (see details in the sections below) and our Global Tactical Fund and Global Tactical ETF kept pace with their benchmarks. Our Private Investment Funds continue to post very solid returns as a number of investments are maturing and gaining liquidity. The most recent example is FitBit, which went public in June and generated a nice return for one of our private funds. We have stated in past letters that we believe that the 2015 to 2017 investment environment will be very similar to the 2000 to 2002 environment and that successfully navigating these challenging times will require an alternative flight plan to the traditional portfolio model. The first half of 2015 was eerily similar to the first half of 2000 (the calm before the storm) and we expect those similarities to continue in the coming years. We have been on this cruise before at UNC and

we believe we have a great navigation plan, based on the Endowment Model, that shows how to preserve, and grow, capital during stormy seas. The combination of a globally diversified investment portfolio that integrates hedged strategies and captures the illiquidity premium through the inclusion of private investments is a time-tested strategy that will stand up to whatever the Gods throw our way.

MARKET OUTLOOK

We repeated the end of the Market Outlook section of the Q4 letter to begin the Q1 Market Outlook and after reading it again, decided it was still applicable, so will repeat it again here, *“Surprises. We think 2015 is likely to be a year full of surprises as it continues to feel a lot like the last time there was so much ‘certainty’ in the markets about New Paradigms and New World Orders, back in 2000. When investors have reached that reflexive maximum and are all leaning one way in certain markets, the impact of surprises is much greater. In 2000, everyone was certain that Internet valuations were reasonable, that Indexing was the only way to invest and that there would never be another Recession because the Fed had abolished the business cycle. Sounds familiar.”* Amazingly, the current stories in the media sound just like the stories in 2000, justifying valuations of certain tech companies by Total Addressable Market (sounds like eyeballs), calling the death of active management because of huge flows into Index Funds chasing hot performance and extolling the virtues of the Yellen Put (instead of the Greenspan Put) to protect investors from ever having to worry about Recessions and market corrections again. Given that our primary themes have been leaning on the cautious side since November of last year when we wrote *Highway to the Danger Zone*, we will reiterate our positions on the big portfolio decisions; we favor Active Management over Passive/Index Strategies, favor Hedged Strategies over Long-Only in the U.S., favor Long Biased Strategies in Japan and Europe over Hedged, favor

Emerging Markets (selectively) over Developed Markets, favor Private Investments over Public Investments (wherever possible with an emphasis on Small Buyouts, Growth Capital (with extra emphasis on EM here), Energy Reserve Acquisition and Direct Lending), and toward Real Assets over Financial Assets. We have also discussed for the last couple of quarters how *“if the 2015 to 2017 period does indeed follow the analog of the 2000 to 2002 period, there will be ample opportunities on the long side, on the short side and in the private markets, even if the overall environment turns out to be challenging for traditional assets.”* The key point here is that having a less than sanguine view on the U.S. equity market does not mean that we don't see opportunities in the markets. In fact, just like in 2000, we see tremendous opportunities to make money, just not in the traditional 60/40 U.S. Stock/Bond portfolios. We discussed last quarter what happened in the markets from 2000 to 2002 and repeating those figures here provides some good context for the balance of the Market Outlook section. The S&P 500 lost (38%) over the three years and then fought back to “only” be down (1.1%) compounded over the next decade (ended up with 90 cents for every dollar invested) and EAFE managed only a scant 1% compound annual return (ended up with \$1.10), you could have made double digit returns for the decade in Emerging Markets equities as they soared 10.5% per year (ended up with \$2.71) or bought Emerging Markets debt and made 9.9% per year (ended up with \$2.57) or you could have hid in REITs and made 9.8% compounded (ended up with \$2.55, much of that from dividends). As we discussed earlier, Hedge Funds produced outstanding returns during the crisis and actually were up about 10% on average over the three years (with some of the best Tiger Cubs compounding close to 20%). We went on to make the point that long-term returns are primarily determined by the valuation you pay when you enter. We discussed that *“if you buy things when they are super expensive like Japan in 1989, U.S. Tech in 2000, or U.S. Financials in 2007, you will lose money and when you buy things when they are super cheap like U.S. Equities in 1982,*

Emerging Markets Debt in 1998, Distressed Debt in 2009, you will make money. In every one of those situations there was a common theme, which is you had to have the discipline (and courage) to break away from the herd and do the opposite of the consensus at precisely the time when it was most difficult to do so, high prices were telling you to buy or low prices were telling you to sell.” George Soros describes this discipline by saying that they always begin with the opposite premise of the markets, that the current price is wrong, not right, and John Burbank says it more succinctly, “price is a liar.”

Julian Robertson commented on this issue during a recent television interview when he said, ***“I agree that the economy is recovering, but one of the biggest drivers of the recovery are bubbles in the financial markets. Those bubbles are eventually likely to bite us. The bubble will burst in a very bad way, they always burst, and that the reason bubbles form is because it’s often hard to see why prices will go down. For example, the drop in 1987 came out of the blue.”*** When asset prices are surging in the late stages of a bubble, it is very challenging to maintain discipline and stay focused on value because of the relentless feedback from rising prices that you must be missing something in your calculation of value. The problem with that perspective is that it starts from the premise of the current price being correct (no matter what the level) and that is why the Soros and Burbank approach to begin from the premise that the current price is wrong is so critical. Speaking of Julian, in reviewing last quarter’s letter (something I do in thinking about how our ideas played out and which of our core themes are most aligned with the current environment), we thought it might be valuable to reprise some of Julian’s best quotes from that letter here, as they are pertinent to our market outlook today.

In speaking of the Internet Mania in late 1999, Julian said, ***“The key to Tiger’s success over the years has been a steady commitment to buying the best stocks and shorting the worst. In a rational***

environment, this strategy functions well. But in an irrational market, where earnings and price considerations take a back seat to mouse clicks and momentum, such logic, as we have learned, does not count for much. Investors are rightly fascinated by the Internet, but they wrongly don’t include price in their equations. It’s going to end in a real blood bath.” Given that we believe we are in a similar environment to the 2000 to 2002 period, the message of this quote is an important one for investors to focus upon as they think about positioning portfolios. We know, with the benefit of hindsight, that investors could not see how prices of great Internet companies could fall in 2000 and that there was indeed a real blood bath over the next three years. The right decision then (and probably now) was to take profits and step away from those segments of the markets and reallocate capital toward the more value-oriented segments of the market despite the consensus in the popular press that value was dead. In closing down the Tiger Fund a few months later, Julian wrote, ***“Life and investing are long ball-games. The people who were cynical and jumped in and played this boom are going to win this game. But to take risk against your fundamental belief, wonder if in the long run that will work. I have great faith that this too will pass. The difficulty is predicting when this change will occur and in this regard I have no advantage.”*** We would echo his sentiments that we have no advantage on predicting precisely when the realization of value will occur and when the economy and markets will rebalance. That said, we also believe that while we can’t predict, we can prepare, and it makes sense to begin rotating toward a more defensive posture, add more hedging in the equity markets and look for ways to deploy capital in the private markets where you can buy attractive assets at more reasonable valuations. Global financial markets are orders of magnitude more complex today versus a couple of decades ago, and that means each successive bubble bursting causes greater dislocations. The judgment to stay with the trend (be fully invested) and protecting against the downside (moving to the sidelines) is one of the

toughest, but perhaps the most important, decisions in investing. 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.

Speaking in a television interview earlier this year, Julian said, ***"The thing that worries me the most are the twin bubbles that are developing, certainly the Federal Reserves of all the countries, the people that run their Treasury operations, are trying to really create a bubble in bonds and they're doing it and bond yields have never been anything like that."*** His timing was impeccable as the German Bund yield was hitting low single digits and some countries with dubious debt burdens like Italy and Spain were selling bonds at lower yields than the U.S. Treasury. We know, again with the benefit of hindsight, that there was a very substantial amount of global capital that was trying to front-run the ECB and buy European government bonds ahead of the commencement of the European version of QE and that frenzied activity set up some amazing opportunities on the short side over the past few months. There are other factors at work in the Bond markets including a Demographic bulge of global investors with a meaningful preference for fixed income investments and a rapidly dwindling supply of high quality bonds. The combination of higher demand and lower supply always leads to higher prices (and lower yields) and we would expect this trend to continue for a while. Another issue related to the ECB is the desire of the European countries (and Germany in particular) to have a weaker Euro and Julian commented on this phenomenon in saying, ***"I think the Dollar will continue to strengthen. I mean Europe needs a strong Dollar and I think they're going to do their best to cut the value of their currency and all this sort of creates a very difficult market to save in and a very easy market to borrow in and those two things are not conducive to long term prosperity."*** The Euro was engineered to be weak by including all the countries that had historically been able to devalue against Germany and France. The EU created a

mechanism to promote Mercantilism at its finest. The surge in exports and profits for German and French companies has been quite robust and the ECB's latest foray into QE was to help accelerate the downward trajectory in the Euro (exactly what we have seen), which translates into a stronger Dollar. The problem, as Julian identifies it, is the incentives are for individuals and companies to borrow, not save and invest, and that combination is not good for long-term prosperity. However, it is conducive to short-term equity market gains, so Don't Fight the ECB is the new mantra to go along with Don't Fight the BOJ as the Fed takes some time off from the QE induced currency wars. On the contrary, the U.S. is on the verge (according to everyone, except us...) of doing just the opposite of QE and increasing rates. Julian predicted this earlier this year when he said ***"I expect a rate increase this year. I think the economy warrants it and I think they're not going to be crazy enough just to let this thing boil over into complete explosion. I think the equity rally will be stalled by an increase in interest rates and I don't think it's at all ridiculous to think about a 2008 size decline."*** It is the second half of the quote that should make investors a little squeamish as he says in a matter of fact way that we should expect a meaningful correction when the Fed finally does raise rates and he says that the (40%) drop we saw in 2008 (peak to trough was actually 57%) is not out of the question. We wouldn't disagree with the magnitude, but we don't think it will happen in a couple of quarters, but rather over the course of two to three years.

So WWJD in this case is What Would Julian Do? He sums up his investment philosophy in a couple of sentences that sound extremely simple and straightforward. The problem, of course, is that it is like a professional golfer saying you just drive the ball down the fairway, hit an iron to the green and two putt, simple game. Julian says ***"Our mandate is to find the 200 best companies in the world and invest in them, and find the 200 worst companies in the world and short them. If the 200 best don't do***

better than the 200 worst, you should probably be in another business. So the basic recommendation is to move capital away from long-only and into long-short strategies where you can substitute Beta risk for Alpha (manager skill in stock selection). The problem with the second half of the statement is that there will be periods (like the five years we have just lived through, or the five years from 1995-1999) when the worst companies don't underperform the best companies. In fact, something very strange happens from time to time in the equity markets, the worst companies actually go up more than the best companies and hedge funds suddenly look like the dumbest game in town. The most interesting point here is that just when the cacophony is the loudest that everyone should index everything and never pay hedge fund fees again, the environment reverts to normal (where normal is defined as good companies go up and bad companies go down). We believe we have re-entered the normal zone with the cessation of QE in the U.S. last fall and long-short strategies are indeed outperforming and should continue to do so for a while. If you have to own something on the long side, Julian describes just what to buy today in saying ***"I like the great growth companies and I think that's one of the great things about being older is you remember back what great growth stocks sold for in earlier times and I don't really think Google, Apple and Facebook have those valuations today. If those stocks had the 1980s and 1990s multiples, they would be double and triple their current prices."*** We are in strong agreement here as we have seen a very interesting divergence in the valuations of some of the fastest growing companies. The combination of very strong revenue growth and high margins (for the best companies in each segment) coupled with investor skepticism on the durability of these disruptive innovators has led to the best companies selling at lower P/E multiples than some of the worst companies. We have seen this phenomenon up close, as these are the names that dominate our MC Direct Top 20 portfolio, which has outperformed the S&P 500 over the past two-plus years.

Finally, Julian talks about the qualities that make a good hedge fund manager and we would expand that to the qualities that make a good investor. He says ***"To be a good hedge fund manager you have to be absolutely honest, intelligent and be able to get along with a team, but we found that true competitors are usually the best hedge fund managers. I think there is something strange in that the make-up of the most successful hedge fund people. They have a real interest in making this world a little bit better than it was when they got into it."*** Intellectual curiosity, technical abilities and collaborative skills define the best investors, but it is the focus on values and integrity, that differentiates the most successful from the rest. There are givers and takers in this world and the givers have an edge over the long-term. I have been quoted many times saying that I believe Julian is the greatest identifier, trainer, developer and backer of talent that our business has ever seen. He is also the most competitive person I have ever met. The thing I admire most about his business model today is that he constructs his core portfolio by supersizing the very best ideas from the very best investors on the planet, most of which he has trained and subsequently backed or seeded. We have taken this page from his playbook and integrated that strategy into our Hybrid Funds and Direct Fund and the results have been quite strong.

Taking a quick tour around the world to look at opportunities in each region, we will start in the U.S. where our view hasn't changed much from the end of last year. Without the easy money of QE to push up the equity market (40 S&P points per \$100 billion), we were hard pressed to see how anything beyond flat was very likely. And that was the upside case. There was clearly a logical case to be made that with every measure of valuation strained, there was a non-zero probability that 2015 could be a negative year. We wrote last quarter that, ***"like Julian, we have no particular edge on being able to determine exactly when the bubbles will burst, but we can heed his warning to increase our level of caution and have***

more exposure to the handful of places around the world where we still find cheap assets or high growth.”

Translation, we should move to a more hedged posture in the U.S. and venture abroad in search of better opportunities. That said, there were still a few places in the U.S. where we thought there were opportunities for highly skilled managers to extract alpha and we continued to allocate to those segments. Our favorite has been healthcare and while we missed the biotech train (big miss, actually, as that market has been spectacular for five years), we have found a couple of managers who have put up lights out numbers by focusing in specialty pharma and medical devices. We have also continued to find some interesting opportunities in technology, although the sector is getting awfully narrow and only a very small number of names are rising, but boy are they rising (NFLX, GOOGL, AMZN and FB). Actually, the very best opportunities we are seeing in tech, however, are in the private space, growth equity investments in companies like Uber and Lyft, where we believe we are buying at a material discount to the ultimate public price (like the Alibaba investment from last year). Given where valuations are today, and given what our expectations are for growth (or lack thereof), we could make a compelling case to not have much capital at all in the U.S. equity markets, but that might be too extreme a position to take today. Depending on what Ms. Yellen does in September, it may actually turn out to be a good idea.

Shifting to Europe, we had been waiting on the ECB, but when they finally found a way to do their version of QE, we wrote last quarter that *“the game plan in Europe is fairly clear, don’t fight the ECB, stay long and strong so long as Super Mario keeps the member Central Banks buying government bonds.”* That strategy has had mixed results over the past few months as fears related to the Greek crisis led to bouts of selling pressure amidst the constant din of liquidity fed buyers looking to front-run the ECB the same way they had front-run the Fed for the past five years. It is a funny thing that if you give people money for free they will buy stuff with a yield and push prices up to

levels that could create real systemic risks (or not if the CBs keep the pedal to the metal). We also wrote last quarter that, *“the other factor as work here is that there is a real economic recovery going on across Europe and that should create increasing opportunities for companies to increase profits.”* While the recovery is not huge (and some of it has been derailed by the Troika plunging Greece into capital controls), it is a recovery nonetheless, and with higher GDP growth in places like Spain and Ireland comes higher profits. Interestingly, the Irish market has been on fire this year, up over 20% (along with Italy, which actually hasn’t recovered as well) while the Spanish market has barely broken even. Capital flows don’t always follow the data perfectly. While in London last week meeting with our favorite European managers it was interesting that two of them were having huge years (up around 17%) and they were practically ebullient about the prospects for stock picking in Europe in the near term. They saw relatively strong top line growth, but very strong profit growth as the result of the much lower Euro (Mercantilism at its finest) and from advances in technology like Big Data that was helping strip out costs and enhance profits. The other area where there was great excitement was in the banking sector where the managers saw significant turnarounds and the potential for very meaningful returns in the peripheral country financials. Interestingly, everyone has basically written off Greece for now and there was not a word about contagion risk in the event that a deal could not be worked out. What an amazing difference a few months makes in how people perceive risk.

Japan. What more can we say about Japan that we haven’t said over and over since 2012? Still our favorite developed market. Still making record profits. Still managing the Yen downwards, slowly and more cautiously now. We wrote a couple quarters back that, *“while there has been a growing chorus of skeptics on Japan (and Abenomics in particular) we are emboldened in our positive view of the Japan market by Sir John Templeton’s reminder that bull markets grow on skepticism.”* The more people

hate on Japan (and there are still plenty of them around, surprisingly), the more excited we get, and the fact that no one is going to see our favorite Japan managers is music to our ears. Our experience over time has been that there is an inverse correlation to the next year's returns and the number of potential client meetings a manager has, remembering that human nature is to buy what you wish you would have bought and be seduced by the hot track record (despite the fact that mean reversion shows that the following years are likely to be less robust). One of the tenets of Abenomics was to weaken the Yen and that helped the exporters, but we wrote last quarter that, *"the rest of Japan Inc. has joined in the profit party as overall Japanese corporate profits are at record levels. We will continue to be long Japan and will affectionately refer to it now as the Land of the Rising Stocks."* In speaking with our favorite Japan manager in London last week, they remain very bullish, fully invested and making a huge bet on the financials, in particular the Mega-Banks (SMFG, MTU, MFG). The potential for unwinding of their cross shareholdings is a huge deal and these stocks could rise 50%+ in the coming year. Another theme was the change in corporate governance in places like Hitachi (which they see as a huge winner) where sharing cash with shareholders, once a novel concept, is becoming a priority of management. Will wonders never cease?

Emerging Markets have suddenly become a dirty word and the EM currencies have gone into a complete meltdown in the past two months. We talked about the FX issue last quarter in saying *"we also have to factor in the impact of changing global liquidity on the EM currencies and how those FX fluctuations will impact our returns as U.S. based investors,"* but we had no idea that there could be so much pain, so quickly, in a Dollar environment that has not been that strong. After having an amazing run in the first four months of the year, EM has now given back all the gains and has been in total free-fall for the past few weeks. We discussed last time how *"when we look at Emerging Markets we need to divide them into two groups, Service based economies like India, Taiwan*

and China and Commodity based economies like Russia, Brazil and Mexico. The global economic growth slowdown, the slowing of commodity demand from China as they shift from fixed asset investment toward consumption and the rapid decline in commodity prices are net negative for the Commodity countries and are net positive for the Service countries." This differentiation has helped a little in that China and India have been volatile (China has been crazy volatile), but have been positive, while Brazil and Russia have gotten whacked as oil prices rolled over in June. One of the managers I was with in London last week (the same one who said the Brazilian Real could go to 4, when it was 2...) said that every crisis needs a surprise and he made a case that the big surprise this time would be Mexico collapsing under the weight of a failed oil hedging program. I won't go into all the specifics, but suffice it to say that for years the Mexican government had made very nice returns by buying protection against oil price declines and then they decided to try and "cut the price" by doing something called "put spreads" and let's just say the only way that doesn't work out is if you underestimate how far oil could fall. Oops. By his calculation, the Pemex losses could double the debt of Mexico and cause the Peso to lose 50%. Those numbers are not in anyone's spreadsheets today and would cause some panic in EM. We just did our Around the World Webinar on *Build Your House With BRICS: Why Emerging Markets Rule* and while that is our long-term view, we must acknowledge the risks in the system today and remain a bit more cautious in the short-term.

The bottom line in the Bond markets is that inflation will not hurt bond returns as global excess capacity and low velocity of money supply are putting little, to no, pressure on inflation. That view (which we borrowed from Van Hoisington and Lacy Hunt) is clearly a Variant Perception and we wrote last quarter that *"the idea that longer duration fixed income will continue to a very profitable investment as interest rates in the developed world should remain under pressure from the Killer Ds of Demographics, Deflation and*

Debt” is a Variant, Variant Perception (if such a thing exists). What people are missing on interest rates is that the real rate today is the same as it was 20 years ago despite the fact that long bond yields are 3% today versus 9% then because inflation has fallen from 6% to 0%, thus a consistent 3% real yield. It is highly unlikely that the secular low in yields has been reached at a 3% real yield, so long duration treasuries should continue to be an asset that surprises people in how profitable it can be. Remember that no one believed JGB rates could fall to sub-1% in Japan and people tried to short them for over a decade, losing money the whole time, which is why that trade has been called the Widow Maker.

The only word that comes to mind when we talk about commodities is bloodbath. It has been simply brutal for anyone who has tried to invest capital in anything resembling a real asset in the past year. We had discussed at the end of last year how we had made “*an Energy shopping list of attractive names that we would want to own at certain price levels. EOG, FANG, CPE, WLL, PXD, RSPP and RICE.*” Given our thesis (Surprise #8) that oil prices would stay lower for longer, we hesitated to buy into this sector earlier this year and were feeling a little sheepish (read *wrong*) as oil jumped from \$44 to \$60 between St. Patty’s Day and Memorial Day. However, we toed the line and wrote last quarter that “*we are not convinced yet that there won’t be one more drop in oil prices as the excess storage is liquidated in the summer, so we may get another shot to buy our favorites on sale. We expect energy to remain highly volatile for the balance of the year and we will be spending a lot of time looking at opportunities in both the debt and equity markets for all of our portfolios.*” Those words turned out to be right and it has been a brutal few months for all things related to oil and gas. Those specific names have plunged, on average, about (20%) since we wrote the last letter (with two outliers, CPE is actually up 10% and WLL is down (45%)). The metals have been crushed, particularly the gold miners. The Ags have been wildly volatile and highly unattractive given the enhanced weather risks related to El Niño. The

declaration of the death of the Commodity Supercycle has reached cacophonous proportions and we can’t help but think a little bit contrarian here and remember that whenever we have seen unanimity of thought on any topic in investing, it has usually been a good time to take the other side. Another point for this view is that the Dollar has historically peaked just as the Fed actually raises rates (buy the rumor, sell the news), so with a September lift-off looking more and more likely, maybe the time to start thinking about commodities is approaching.

So let’s conclude this section with a quick review of some specific ideas that we liked coming into the first half of 2015 and see how those ideas are shaping up so far. We’ll start at the end of last year where we wrote in *Highway to the Danger Zone* “*about how it might be time to play a little defense by going long IWL (large) and short IWM (small).*” We gave an update on that trade last quarter and wrote “*for the first three and a half months of 2015, this was a bad idea as IWM surged 6.5% and IWL was only up 2%, but in the last couple of weeks that gap has completely closed and they are now both up only 1.5% and we reiterate that this is likely to be a nice market neutral trade for the balance of 2015.*” Over the past three months the U.S. equity market has been quite volatile (within a tight range) and it was déjà vu all over again (to quote Yogi Berra) as this trade was quite poorly for the first six weeks when the spread widened almost precisely as it did in the first few months of the year, with IWM up 6% and IWL only up 2%. Then in the past six weeks the momentum shifted again and IWM dropped (7.5%) and IWL fell only (2%) so the defensive spread worked over the whole period. For the CYTD, it is nearly a dead heat with IWM up about 0.9% and IWL up 1.3%. Importantly, however, only five short weeks ago, IWM was up 8.5% and IWL was up 3.5%, so the trend in this spread is decidedly negative and we expect that this defensive pair is likely to generate a very nice return through the end of the year. Coming into 2015, we cautioned that biotech looked a little rich and that IBB potentially looked vulnerable. As we wrote last quarter “*that was a terrible call as it surged*

20% through mid-April before finally succumbing to the law of gravity and dropping (10%) in the past couple of weeks (although still up 10% CYTD) and we do think that there could be some real downside here for those with a tolerance for volatility.” Once again we have to write that this concern about biotech valuations has gone unheeded as investors pushed these companies up another 4% over the past three months (versus a 2% drop for the S&P 500), bringing CYTD returns to an eye-popping 21%. We are finding a little (very little) solace in the rapid (8%) drop over the past few weeks (which took CYTD returns down from 30% in mid-July). Time will tell if we are “early” or “wrong” on this sector, but given the high volatility, it might be best to just leave this part of the portfolio to the experts as it is very challenging to make fundamental investment decisions based on little to no financial information (many of these companies have no revenue, let alone no profits). Some of the new science in biotech is truly awesome and there will be many new blockbuster discoveries that generate billions of dollars of profits, but there will also be many failed clinical trials and untoward outcomes that leave investors with total losses so perhaps it is better to go long a basket like IBB or build a basket of the biggest companies like AMGN, GILD, REGN, CELG and let them determine who the winners will be through acquisition. One other way to play in biotech is to own the toolmakers, like Illumina (ILMN).

We have discussed the theme of the battle between Old Tech (MSFT, INTC, ORCL, HPQ) and New Tech (PCLN, EBAY, GOOGL, NFLX, FB, AMZN) over the past year as the war between the laptop and the smart phone has raged on and we believed that the New Tech guys had the edge. We wrote last quarter that *“it hasn’t been much of a fight in 2015 as these names are up 2%, down (10%), flat, down (18%) for Old Tech and up 4%, up 4%, up 4%, up 63%, flat, up 38% for New Tech. We expect this trend to actually accelerate as fewer and fewer PCs are sold. We heard the 12 inch iPad (the laptop killer) is coming soon, so AAPL will continue to make life tough on the old tech guys.”*

The last three months lived up to our expectations as Old Tech returns were flat, down (10%), down (9%), down (10%), while the New Tech guys surged 9%, 17%, 23%, 53%, 20% and 23% respectively. The only negative in the New Tech group was Apple where they delayed the new iPad and guided slightly less positively (read not negative, just less positive) and fell (7%). We see no letup in this trend in the coming quarters; however, the valuations in New Tech land are a little stretched in some cases, so in the event that there is a material correction in response to something like a Fed rate hike this fall, those names could be more vulnerable to the downside than their lower-priced, Old Tech cousins. We would view any relative outperformance by the Old Tech guys as a pause that refreshes in the long-term trend and would be quick to redeploy capital to build larger positions in the New Tech names at lower prices.

We have argued for many quarters that the Big U.S. Banks have been “Dodd-Franked,” that all of the new post-GFC regulations have turned them into Utilities by restricting their ability to lever up to levels necessary to generate adequate returns in a ZIRP world. We wrote last quarter that *“this view has been solid, as the banks have struggled with C down (2%), JPM up 3%, BAC down (8%), WFC up 2%, GS up 2% and MS down (3%). With restrictions on prop trading also hampering profits, if the one source of revenue growth, M&A activity cools in a Recession or market downturn, these companies could really struggle.”* The good news for the Banks over the past few months has been that the M&A activity has actually accelerated and the rising consensus that the Fed will raise rates in September has investors believing that Net Interest Margins will rise. With those temporary tailwinds, the banks turned in a solid three months and rose 8%, 6%, 5%, 9%, 3% and 3%, respectively. The gains were inversely proportional to the size of the January drawdowns when investors were concerned (we believe correctly) about losses in the banks’ energy derivative books. We discussed this issue in the Q4 letter in saying *“the banks have huge derivative exposure and loan exposure to the energy*

industry that could cause some pain as the market begins to adjust around mid-year, so the swoon in bank stocks in January could be foreshadowing some interesting times ahead.” The banks made the decision rollover LOCs on some very suspect borrowers in the energy complex in April, so there were no mark-to-market losses to be taken, but as the October reset date approaches, oil prices have given back all of their gains during April to June and some of the balance sheets in the oil patch are looking awfully weak. The high yield bonds of these companies have turned back down sharply and the equities are down 60% to 70% (or more) in some cases. It is hard to believe that there isn't some bad bank debt in these capital stacks and that there won't be some pain in the Q3 and Q4 bank earnings. As always, time will tell whether the gains of slightly higher NIMs will offset the sins of the past loans, but we still believe that the upside for U.S. banks is capped and that there are much better opportunities to buy financials in other places around the world. We think the Japan Mega Banks (SMFG, MTU, MFG) are significantly better growth stories and the French (FR:ACA, FR:BNP), Spanish (ES:SAB, ES:BKT, ES:POP) and Italian (IT:BP, IT:UBI, IT:PMI) Banks are much better value stories with many of them selling significantly below book value. You can also buy baskets of these banks in DXJF and EUFN.

We argued in the 10 Surprises (in the bonus 11th Surprise) that lower gas prices would not necessarily equal higher consumer spending (beyond mini mart fare and casual dining) as consumers rather used the savings to pay down debt or increase savings. So the fact that XLY, the Consumer Discretionary ETF, is the second best performer this year behind Healthcare (XLV) has been a bigger surprise. We did write in Q4 that companies *“like BBY, BBBY, JCP and SHLD could run on PE rumors”* and followed that up last quarter by saying *“but 2015 has been a mixed bag with returns of down (9%), down (8%), up 30%, and up 26%, respectively.”* Takeover rumors have subsided and the fundamental realities have set in for this quartet of Old School Retailers and those results have

not been pretty as the stocks have fallen (15%), (10%), (1%) and (35%), respectively. Apparently e-commerce continues to really chip away at brick & mortar retail. The other consumer segment we have favored for a long time has been the Airlines (since October 2012) and while airlines had a great 2014, we wrote last quarter that *“they have struggled so far in 2015 with AAL down (12%), DAL down (10%), UAL down (10%), LUV down (5%) and only JBLU has managed to buck the trend, rising 35%. Clearly investors are worried about rising oil prices, which while up 13% in 2015, are still down 40% from 2014, so we think they are missing the huge EPS boost coming from lower fuel costs. We expect the airline stocks will fly again as they are selling at way too cheap single digit P/E multiples and have strong growth prospects.”* The past three months have not helped our view despite a collapse in oil prices back to new lows and continued high traffic volumes at airports. The stocks were down big again for the most part with returns of (15%), up 2%, (10%), (10%) and up 9% and the low valuations got lower. Fears of price wars and new capacity coming on stream in 2016 and the threat of a DOJ investigation into price collusion (very populist right before an election) have conspired to make the airlines “stupid cheap” (as I called them on CNBC in June). We are mindful of how the DJ Transports are a leading indicator of a slowing economy, so we are continually weighing the relative attractiveness of these very cheap (albeit cyclical) companies versus more highly priced growth stocks should a U.S. Recession actually emerge.

Speaking of cyclicals and Recession indicators, we wrote in the Q4 letter that *“the cyclical stocks have been behaving as if growth were going to accelerate (hope springs eternal), so we will keep our eye on the semiconductors as they are a group that usually signals stronger growth ahead, so names like BRCM, KLIC, MRVL, LLTC, MSCC, NVDA, TXN, MU and QCOM will be bellwethers.”* The news was mixed last quarter as we wrote *“these names have mostly struggled in 2015 with returns of 5%, (6%), (5%), (1%), 15%, 10%, 1%, (20%) and (8%), respectively, so we*

think that would point to economic slowing ahead.” With U.S. GDP coming in at 0.6% (thanks to a late “adjustment” that increased it from negative...) and the first estimate for Q2 coming in at 2.3% (average of 1.45%), it appears that growth is indeed slowing. In fact, slowing so much that the Fed continues to have to ratchet back full year forecasts (given their awful track record of forecasting, why do they even try?). Looking at the returns for the semis over the past three months, it appears that these stocks have accurate leading indicators once again as only BRCM & NVDA managed positive returns and all the others were down, with the group having the following returns, 9%, (22%), (11%), (9%), (1%), 3%, (7%), (32%) and (8%). Along with the Four Horsemen of the Growthpocalypse and the Dow Transports, indicators pointing to a slowdown in growth in the coming quarters are beginning to pile up. With most of these stocks plumbing the depths of new lows there is one thing to watch for in this sector. There have been unsolicited bids within the sector (like MU) and there are rumors about a couple of the other names (like QCOM) being on the buy list of some smart investors. It is possible that these stocks have seen the bulk of the downside and it might make sense to keep them on the radar screen if they begin to make a turn (like TXN has recently).

One contrarian sector idea we have been talking about since last year is in the Defense area as the focus had been on the cuts in the U.S. due to sequestration, we wrote that *“we expect continued strong growth in Defense as geopolitical tensions rise and countries like Japan and China increase military spending, which played out well in Q4 and started strong in 2015, but has been weaker of late, leaving LMT down (3%), GD flat, BA up 10% and NOC up 5%.”* With tensions rising over the pending Iran nuclear deal, intermittent flare-ups from ISIS and other terrorist groups and increased rhetoric between China and Japan, there has been renewed interest in defense companies. The prospect of a resumption in U.S. defense spending in 2016 has also helped push these names up nicely over the past few quarters and the stocks rose again in the

past three months, up 11%, 8%, 1% and 13%, respectively. We would add EADSY (Airbus) to this list and believe that the tailwind for military spending will continue to strengthen. As the world continues to grow larger, more complex and more connected, the potential for surprises increases (both positive and negative) and the desire for countries to be more well-prepared to manage conflicts will create strong demand for defense contractors for many years to come.

So speaking of surprises, let’s take another look at our 10 Potential Surprises for 2015 and see how things are shaping up at the mid-point of the year.

10 Surprises Update

Our January ATWWY Webinar was entitled *Channeling Byron: 10 Potential Surprises for 2015* (with a nod to Byron Wien, the former Morgan Stanley Strategist who originated the annual 10 Surprises idea). We recapped these Surprises in the Market Outlook section last quarter, as they seemed like a perfect baseline for our current view of the world. An important point about Surprises is they are intentionally non-consensus and have some reasonable probability of not occurring. The unlikely nature of a true Surprise fits in perfectly with the Soros quote above about 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 that point, the definition of a Surprise is a Variant Perception (an idea that is materially different from consensus) that we believe has a better than 50% chance of occurring in the current year and the key is that it must be *materially* different. We discussed one other important point to be mindful of, saying *“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 also be ready to change our minds (and our positioning), should the facts change.” So the following are some quick updates on how the surprises are faring at the second turn (to stay with the horse race theme) with notes on places where we may need to change our mind as consensus is shifting (italics are from last letter and new commentary is regular font).

Surprise #1: The Lula Pivot. In a déjà vu experience harkening back to the 2002 Brazil elections, the radical Syriza Party wins the Greek Election (this was still a potential surprise since I wrote that before the election), but Alexis Tsipras turns out to not be as extreme to the left as expected (just like Lula) and the Greek equity market surges (just like Brazil did for next five years), turning out to be one of the best performing markets for 2015.

To this point, we would have to say this surprise is not going according to script. Too much posturing and too little liquidity have led to some rapid deterioration in the GGBs and while the equities had clawed their way back to even with the U.S. at the end of April, this week has been tough and GREK is down 7% again and the banks are still down (20%) to (30%). The game of chicken between the new Greek government (and their not so tactful Finance Minister) and the Troika is nearing its end and we believe that when the drama is over, there will be no Grexit and Greek stocks and Greek Government bonds will surge.

It appears that we got this Surprise approximately right, but precisely wrong as it turns out that Prime Minister Tsipras did indeed do an amazing pivot to the center (so much so that it cleaved off the radical left from the Syriza party), there has been no Grexit and there appears to be a third bailout package on the way from the Troika. That said, the EU decided to play hardball and make an example out of Greece in order to discourage Podemos in Spain (and others) from getting any ideas about challenging the Troika. They withheld emergency assistance from the banks

during the final stages of the negotiation and forced Greece to impose capital controls, close the banks and close the equity markets. Things were actually looking pretty good up to that point in June, but this move will likely result in another restructuring of the banks and make Greek equities a poor investment for 2015. With GREK down 30% and the banks down between 60% and 85%, the hole is simply too big to fill even if the rest of the bailout process goes perfectly (unlikely anyway). We still believe GGBs will turn out to be a solid investment for the year and one small positive is there are some serious babies being thrown out with the bank bathwater like GR:OPAP (gaming company), GR:AEGN (Aegean Airlines), GR:HTO (telecom company), GR:EXAE (Hellenic Exchange) and GR:PPC (power co) that could provide solid returns from this point forward.

Surprise #2: Turning Japanese, I Really Think So. Despite the BOJ and the ECB picking up the QE baton from the Fed and committing to purchase \$80B and \$65B of government bonds each month respectively, Deflation reemerges as the primary economic challenge in the developed world, GDP growth stalls and global interest rates continue to fall.

This surprise was going along like clockwork during the first quarter with global bond yields making new lows seemingly every day and even slipping into negative territory for large swaths of Europe. The German 10 year Bund yield had fallen from 55 bps to 5bps, but then in mid-April rates exploded higher as a number of large fixed income managers revealed they were short and yields bounced all the way back to 55 bps. Many investors who have lost a lot of money being short bonds over the past two years are now declaring victory (even though they are still down a lot...), but we remain in the #Lower4Longer camp for now as we expect more disappointment on the global growth front.

Global growth has indeed continued to disappoint, yet there was continued pressure on global interest rates for the bulk of the second quarter until the fireworks

began around the Greek debt situation when they missed a bond payment on 6/30. Global markets had been volatile in a very tight range all year and global bond yields had reversed all of their declines up to this point, but have now resumed their slide. While the Greek Crisis appears to have left the stage, the impending move by the Fed to raise rates in September is now front and center, and should equity markets continue downward, the flight to quality could accelerate and global rates will continue their downward journey. One thing that has slipped by many market participants is the Deflationary impact of a strong U.S. Dollar and it is highly unlikely that interest rates rise when inflation expectations are falling and developed markets CPI gauges are stuck around the zero bound.

Surprise #3: Let's Do Limbo Now. Contrary to the Fed Dots (new, new thing), the preponderance of Economists' predictions (just like in 2014) and the continually upward sloping Fed Funds futures curves (since 2009), the Fed does not raise rates in 2015 and long bond rates take out the 2012 lows in yield.

The U.S. 10 year had started the year at 2.2% and had fallen all the way to 1.63% in February was hovering at 1.75 in April and has surged back to 2.2% in a matter of weeks. Many investors burned by the sharp fall in rates over the past two years are saying the Bond Bull Market has officially ended, just like they have every year since 2009. We will take the Under. Updating the housing and fixed income sub-themes, the housing stocks have returns CYTD of XHB up 2%, LEN up 4%, PHM down (5%), KBH up 20%, DHI up 4%, TOL up 4% and RYL flat, while the asset managers have returns of BLK up 6%, BK up 18%, LM down (2%), FII up 9%, WDR up 7%, STT up 8%, all compared to the S&P 500 up 1%.

This Surprise had looked pretty prescient over the first six months as there was broad consensus at the end of last year that the Fed would raise interest rates in March, or at the latest, June. But here we are in August and now everyone is absolutely sure that Ms.

Yellen will pull the trigger in September. While we will contend that the data is still terrible and that raising rates and reducing liquidity will be viewed with the benefit of hindsight as a significant Policy Error, we can feel the momentum shifting toward a stance of the Fed having to do something now in order to maintain any sense of credibility (some might ask if they ever had any). The long bond did take out the 2012 lows of 2.5% and got all the way down to 2.25% before spiking a quick 100 bps back to 3.25 before settling back into a downward trend recently and are back to 2.8%. So regardless of the answer to the will she or won't she question, we got half this Surprise right, which is nice.

Surprise #4: Here's to You Mr. Kindleberger. Confounding the conventional wisdom that the convergence of the 3rd year of a Presidential Cycle (average 21% return since WWII) and the 5th year of a decade (no down years since 1905) virtually guarantees a positive return for U.S. equities, the S&P 500 breaks the string of six consecutive up years and suffers its first losing year since 2008.

We discussed Charles Kindleberger's Cycle Theory earlier in this letter, but again quickly, he posits that the economy and markets follow a seven-year boom/bust cycle driven by repeatable investor behaviors. Given the last two cyclical peaks were in 2001 and 2008, we would be due for another peak in 2015 that would result in disappointing returns for U.S. equities. The S&P Composite has never been up seven years in a row. A scant 1.9% return with a lot of negative momentum in the markets seems to be in striking range of our target outcome. With Julian sounding the alarm last fall, we expect some real fireworks in Q4 this year if history rhymes.

The S&P 500 virtually made no progress in the past three months and is stuck at a 2.1% return for the CYTD with more than half of that return coming from dividends. In a normal year three of the Presidential Cycle, the market would be up double digits by now and given the strong trend and momentum

indicators coming into 2015, the low returns are even more unexpected. There are a number of technical indicators breaking down in the equity markets that bode well for this Surprise. The number of stocks below the 200 dma is at levels that have normally been associated with corrections, the DJIA is well below the 200 dma and the S&P 500 itself is flirting with beaching the 200 dma as well. The biggest problem, however, is fundamental. There is simply not enough revenue and earnings growth to justify current multiples and if the only support holding up the market, low interest rates, gets pulled in September, it could be a very tough fall for the market.

Surprise #5: TMI Writ Large. Despite an ongoing military conflict in Ukraine, the impact of coordinated global economic sanctions, rapidly falling oil prices, reduced government tax revenues, a collapsing currency and a looming economic downturn and downgrades of their government debt and consensus that Russia is simply “un-investable,” Sir John Templeton turns out to be right that Bull Markets are born on Pessimism and Russian equities turn out to be one of the best global markets in 2015.

We couldn't have scripted a better first four months for the Russian Rebound sequel (just like 2009). Surpassing even our best expectations, the stabilization of the Ruble (up 20%), a recovery in oil prices and a general sense that things really had gotten to cheap in Russian equities has driven the markets up sharply from the lows of Maximum Pessimism on December 15th of last year. CYTD our favorite Russia names are up big, with RSX up 37%, LUKOY up 34%, SBRCY up 56%, OGZPY up 34% and VIP up 25%. We think there is a lot more to come here as we are still in the Pessimism phase and have yet to get to the growth stage of a Bull Market, Skepticism.

For the first four months of 2015, the Russian markets were performing as expected, decoupling from oil prices and riding a wave a positive momentum created by the strengthening Ruble after the Russian Central Bank raised rates dramatically in December.

Suddenly in May and June, the equity markets recoupled with oil and as WTI slid (29%) over the past three months, many Russian equities followed. RSX fell (18%), LUKOY down (26%), SBRCY down (17%), OGZPY off (29%) and only VIP managed to be up 6%. That is the bad news. The good news is that the CYTD returns for these companies is still quite respectable at 12%, flat, 21%, (5%) and 35%, respectively, as the Ruble has given back (5%) of the gains from late last year and oil has shed (26%). With the ETF up double digits, it is indeed one of the best performing markets in the world so far in 2015. However, with our expectations for continued pressure on oil prices, this Surprise will depend on whether investors focus on the attractive valuation of these assets or the historical high correlation to energy markets.

Surprise #6: All That Glitters. The acceleration of the Global Currency War reignites the demand for the ultimate currency, Gold, and the Barbarous Relic surges to new highs in 2015, carrying the miners along for the ride.

Gold has been basically flat so far this year as the global currency wars have taken a little breather. Gold and silver have been acting more like currencies than commodities of late (usually happens around challenging times). The miners have been much more volatile and after being up 20% early on, hit down (5%) before settling down in the past few weeks. CYTD the metals and miners are both mixed with GLD flat and SLV up 5% and GDX up 7% and GDXJ up 1%. Expect more volatility as the tug-o-war between Deflation and Expansion rages on.

After a truly dazzling first three weeks of the year where GLD was up 10%, SLV was up 15% and GDX & GDXJ were up 20%, the only surprise here has been just how truly awful these assets could perform over the subsequent six months. Since we wrote the last quarterly letter, the metals complex has been in free fall with dismal returns of (8%), (10%), (33%) and (25%) which makes the CYTD returns an equally unappealing (9%), (7%), (30%) and (25%).

Fundamentally and technically, these equities are broken and the combination of a strong Dollar, continued pressure on commodity prices and lots of forced selling from big hedge funds have resulted in a Surprise that we are unlikely to see have a positive outcome. Even the BTD crowd has departed the Gold trade as every time investors say, “it can’t go any lower,” it does. There are plenty of true believers still arguing that the ultimate currency must revalue as paper currencies devalue and that gold miners “must” recover at some point, but the real problem is there are no natural buyers of these stocks today.

Surprise #7: Water Finds Its Level. Central Banks in the Emerging Markets are forced to stimulate their economies in response to the massive BOJ and ECB bond purchase programs and the resulting expansion of liquidity unlocks the extreme value in Emerging Market equities leading them to outperform the developed markets for the first time since 2012.

Someone clearly forgot to send the memo to the Emerging Markets that they were all supposed to roll over and die as soon as the Fed stopped QE and turned off the liquidity spigot. Lo and behold the Central Bankers around the world stepped up and made the hard decisions to stem the FX declines and then began a measured program of expanding liquidity to the local markets. While most pundits were touting the continued dominance of Developed Markets over Emerging Markets in 2015, so far the true surprise is that it hasn’t been close (the other way). EEM is up 10% versus the 1% rise in the S&P 500 and some of the components have been truly amazing with RSX up 37%, FXI up 10%, EWZ up 5% and only India has disappointed, with EPI down (5%). The Frontier Markets have been mixed, with FM up 2% and AFK up 3%, and we expect more good things out of Africa and the Middle East as the Saudi Market opens up in June. While India has given back a little ground as the Modi honeymoon has waned and the real work has begun. We see this as a tremendous buying opportunity and see fantastic growth opportunities ahead as this Asian Tiger market

modernizes and matures demographically.

My, what a difference a quarter makes. Three months ago, this Surprise was looking great, and the 10:1 ratio of return in EEM versus SPY seemed to be signaling another decoupling for the Developing Markets. As Lee Corso of ESPN would say “Not so fast, my friend.” After a stunning 14% advance in March and April (made even more impressive by occurring into a 9% rise in the Dollar), EM turned on a dime and “Sell in May and Go Away” would have been great advice as EEM has collapsed (17.5%) to now be down (6%) for the CYTD and is once again trailing the Developed Markets. The moves in EM have been somewhat counterintuitive as they rallied strongly alongside the Dollar and fell hard in advance of the huge oil correction in July. Clearly some of the volatility comes from the China exposure, which has had an amazing roller coaster ride in 2015. For perspective, since last quarter, EEM is down (15%), EWZ is down a stunning (27%), RSX is off (17%), EPI is actually up 3%, FXI is down (11%) and the Frontier Markets ETFs FM and AFK are down (11%) and (17%), respectively. Much of the losses have been from local currency weakness and there have been huge capital outflows from these markets. It will take real courage to be greedy here while others are being fearful, but on a multi-year time horizon we continue to believe that building your house with BRICs Plus and the Frontier Markets will produce strong long-term returns. Our one highlight market, India, appears to be moving into a true Reform Agenda and we are confident that the combination of Modinomics and Rajan’s leadership at the RBI will drive outstanding returns for patient investors.

Surprise #8: No Fracking Around. Contrary to the current consensus that Oil prices have bottomed and will rebound back to \$70-\$80 by year end, continuing liquidation of speculative long futures positions drives Oil down close to the 2008 lows (\$30) and prices stay in the \$40-\$50 range much longer than expected as structural challenges in the U.S. and OPEC make it difficult for market participants to move supply/

demand back into balance.

Early in the first quarter, this surprise was looking good as a continued slide in oil prices knocked another (18.4%) off the already low price of \$53.27 at year end and WTI hit \$43.46 on March 15th. From that point, something (what, we are not quite sure yet...) materially changed in the oil markets as prices have staged a very strong rally over the past six weeks, rising a stunning 38% to \$60, to now be up 7% for the year. We said we reserve the right to change our mind about a surprise if the facts change and therein lays the conundrum. Seemingly, the fundamentals of the market have actually gotten a little worse as the small drop in U.S. production (60k bpd) was more than offset by a huge production increase by Saudi (800k bpd) and while demand has ticked up at these lower prices, it doesn't appear to be enough to move supply/demand back in to balance. Add the overhang of record stored oil that will come back into the market and you get less balance, not more. For now, we are sticking with the view of the smartest oil trader we know, Pierre Andurand, who thinks we see lower lows later this year, but we are mindful of the fact that no one is right all the time (and he may change his mind, after all he is a trader...) and sometimes you need to just listen to what the markets are telling you.

We were close to changing our minds on this Surprise as there was some evidence that U.S. oil production was beginning to slow marginally and there were some reports of rising oil demand globally that could have been moving the market closer toward balance. That said, we dug deeper into the data and talked to a lot of managers and consultants in the oil patch over the past few months and came away with greater conviction that our original Surprise view was the right perspective. With the price of WTI having fallen from \$60 back to within pennies of the March 17th low at \$43.87 it appears that our fundamental view of the oil markets has been corroborated. The potential for a deal with Iran puts further pressure on global oil markets and we are still siding with Pierre Andurand (just met with his team in London) who believes that the

30s for WTI are coming soon. Not only did he not change his mind, but he has pushed his positions higher and is projecting that the Bear Market in oil will last at least until 2018. The implications of sub-\$50 oil for an extended period of time are quite profound and there will be lots of investment opportunities on both the long and short side that will be created by that environment.

Surprise #9: Only Way Out. Kuroda-san and the BOJ pull out the bazooka again in 2015 taking aim at a USDJPY level of 140 in an attempt to stimulate profits of Japan Inc. so they will raise wages, triggering a virtuous circle to break deflation and achieve the 2% target inflation rate. Japanese equities tag along for the ride and the Nikkei reaches 22,000 by year-end.

This surprise is going pretty much according to script as the Yen did indeed encounter resistance and has essentially remained flat over the course of the first four months of the year around 120. The Nikkei also hit some resistance at 18,000 for a few weeks before surging over the past couple of months to finish just under 19,500 (almost halfway to the target). As we have discussed in the sections above, there have been a lot of places to make really strong returns in Japan this year, like the banks and exporters, but the indices themselves have been solid with NKY up 12% and DXJ up 13% versus the 1% gain in the S&P 500 and the 5% gain in the MSCI ACWI Index. We expect that Japan will continue to be one of the best places around to own equities over the next few years and should also be much more resilient in the event Julian is right and we get a meaningful correction in U.S. equities, due to relative valuations and the fact that there are many overleveraged U.S. companies and many net cash Japanese companies.

Japan has become the Land of the Rising Equities and the past three months have been an example of the resilience of the Japan markets relative to the other global equity markets. Since our last update, NKY is up 1.7% and DXJ is up 0.5%, which are not outstanding results in and of themselves, however, compared

to the SPX decline of (1.1%) and the ACWI loss of (4.2%), they look quite attractive. When looking at CYTD the results look even better as NKY is up 15%, DXJ up 16%, SPX up 2% and ACWI up 3%. With the Nikkei at 20,724, the target level of 22,000 for the Surprise looks quite reachable. The Yen has taken a pause in its depreciation and currently sits at 124, modestly higher than the 120 level where it spent the first four months of the year, but appreciably lower than the 140 target for the Surprise. It looks like without Kuroda-san truly pulling out his bazooka again in the fall like last year we will have to be content with being directionally correct, but perhaps only getting half the Surprise right for the year.

Surprise #10: Goats Climb Mountains. In spite of the cacophony of bad news about slowing GDP growth, an impending economic hard landing, a potential currency collapse, a looming banking crisis and a pervasive real estate bubble, coupled with fears that huge returns in the Shanghai market in 2014 have pushed equity markets too far, too fast, China officially enters a new Bull Market and equities (both Hong Kong and Shanghai) rally strongly again in 2015.

When the Chinese Leadership set their mind to something, they usually get their way and the recent shift of assets from property toward equities is no exception. From increased liquidity from the PBOC to the development of the Through Train Program and expansionary regulations on trading, the message has been clear for Chinese investors to start consuming stocks, now. The results has a been a very powerful move in equity markets over the past year (SHCOMP up over 100%) and our surprise looks pretty darn good at this juncture with the SHCOMP up 31%, FXI up 19%, ASHR up 25% and EWH up 15%. The global financial media has come out in force calling the rapid move a bubble and predicting an immediate crash. The facts are quite different from the reality as valuations for the broad markets are still cheap (not even average, let alone expensive). Yes, there are a few pockets of extreme valuation in some of the small/micro cap markets and most of the new IPOs have been rocket ships,

but the total market cap of these high fliers in relatively small. The rest of the year is likely to see some meaningful volatility, but we would expect Chinese equities to keep rising on the back of the Great Wall of Money moving into the markets.

Little did we know three months ago how accurate the first half of the last sentence in the paragraph above would be. Volatility has been the key word in the Chinese equity markets over the past few months, most of it downside volatility. The “Sell in May and Go Away” mantra would have been very profitable for investors in the China equity market as the Shanghai Composite peaked at the end of April and headed essentially straight down for the next three months, with a couple pauses, while the Government tried to arrest the decline by limited short selling and encouraging funds to buy equities to support the markets. Looking specifically at the market returns, the SHCOMP was down (14%), FXI shed (20%), ASHR dropped (15%) and EWH held up the best, falling only (7%). Despite the dramatic volatility, the China markets have performed relatively well CYTD with returns of 12%, (3%), 7% and 7%, respectively. Going forward, we see that some of the best companies in the A-Share market have become quite cheap again (the market as a whole is also relatively cheap) and offer an excellent buying opportunity and many of the big listed companies in FXI are trading at huge discounts to their Western peers. We still believe that The Year of the Goat has ushered in a new, long-term Bull Market and that by focusing on companies in sectors focused on the consumer, there are very attractive returns to be earned in the years ahead.

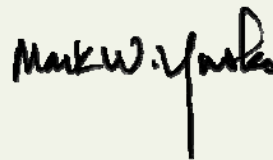
Bonus: Surprise #11: Little Luxuries Not Enough. In contrast to the powerful narrative, the huge wind-fall for U.S. consumers from lower gasoline prices fails to materialize as some of the savings are applied to reduce debt and increase savings and the loss of jobs from the economic downturn in the Oil States counteracts the positive impact of the balance. U.S. Real GDP growth hovers around 2% (for the 6th consecutive year) and talk of QE4 begins in the fall.

There is no question that as gas prices tanked (couldn't resist) last year, consumers had a few extra dollars in their pockets at the gas station and they did indeed buy more stuff at the mini mart and they did stop at more casual dining restaurants on the way home, but the overall impact on the economy was very muted based on the Q1 GDP number of 0.2%. The real problem is that with the newly released trade numbers that include info adjusting for the CA port closures, that GDP number is going to be revised down to a negative number. Surprise! That performance in Q1 almost guarantees that GDP has no chance of hitting 3% for the year. Worse yet, is the Atlanta Fed GDP Now forecast (which was the only forecaster to have Q1 below 1%, they were right on at 0.2%) has Q2 GDP at 0.8%, which would mean we are only a little bit of bad weather away from two negative quarters of GDP, the old school definition of a Recession. That said, after spending the last few hours in the Atlanta airport, we are not in a Recession yet (and our airline investments are going to soar...), but all the talk of resurgent growth seems misplaced given the data.

As expected, Q1 GDP was revised down to negative, but then with a little help from "Revisions" was adjusted upwards to 0.6% for the final number (the previous three years lost a cumulative 1.5% in those revisions for any one keeping score at home) and Q2 came in better than the original estimates, at 2.3%. Both numbers were well short of consensus and indicate a much weaker economy than the pundits were predicting at the end of last year. So the first half of 2015 has averaged 1.45% GDP growth which means we have to have 2.55% on average for the second half just to get to the Surprise prediction of 2%. Everyone is lowering their forecasts for the year now and the 3% to 4% numbers that were thrown around last December are mathematically impossible (unless we get some monster revisions). Interestingly, the huge gas savings windfall never did actually occur as wholesale gasoline prices troughed on January 14th at \$1.11 and ran all the way back to \$3.40 on July 9th before settling back down to \$2.19 today. As we

anticipated, U.S. Retail Sales have come in flat or negative in four of the six months this year, yet Consumer Discretionary stocks have bet on the resilience of the American shopper and have surged 10% for the CYTD, second only to Healthcare.

With warmest regards,



Mark W. Yusko
Chief Executive Officer & Chief Investment Officer

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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.

HFRI 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.

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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. As of November 2012 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.