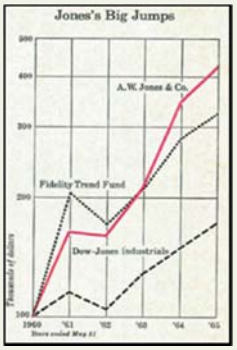
Q3 2015 Market Review & Outlook

Morgan Creek Capital Management

MORGAN CREEK CAPITAL MANAGEMENT

Letter to Fellow Investors

A.W. Jones Was Right: Time To Get Hedged



Source(s): Fortune Magazine.

One of my favorite movies is *Animal House* and in the classic ending scene where the Delta House boys have incited chaos by driving the "Deathmobile" into the middle of the Homecoming parade, Kevin Bacon's character (militant Omega pledge Chip Diller) is imploring the panicking crowd to *"Remain calm, all is well. All is Well! Remain…"* and is trampled into the sidewalk by the crush of people running down the street to escape from the anarchy. There is a construct called Six Degrees of Separation that says that any two individuals in the world are connected by six or less associations. The thesis is essentially that the term "friend of a friend" can connect any two people in less than six steps. The theory was developed by Hungarian author Frigyes Karinthy in 1929 (perhaps an ironic date given the theme of this letter) from his observations in *Chains* that the modern world was shrinking (hence the term Small World) due to technological advances in communications and travel and many of the concepts of his abstract work have grown over years into what we refer today as *Network Theory*. The existential idea was popularized by the 1990 play of the same name written by John Guare and the name was "borrowed" in 1994 to create a trivia game called *Six Degrees of Kevin Bacon.* Three Albright University students invented the game, partly in response to a comment made by Bacon in a Premiere Magazine interview that he *"had worked with everyone in Hollywood, or someone who's worked with them."* The basic idea is that anything can be ultimately linked back to Kevin Bacon in no more than six steps.

Just over a week ago was *Back to the Future Day* (#BTTF) as October 21, 2015 was the date that Marty McFly punched into the dashboard of the DeLorean time machine in the movie *Back to the Future II* thirty years earlier when the movie was set in 1985. When Marty arrived in the future, he looked up and saw a holographic billboard announcing that the Cubs had just won the 2015 World Series. Amazingly, in the weeks leading up to BTTF Day, the Cubs (who haven't won the World Series since 1908) were one of the favorites to win the World Series this year. However, in a further ironic twist, the Mets eliminated the Cubs in the 4th game of the NLCS on the actual BTTF Day. Long suffering Cubs fans have a mantra of *"wait till next year,"* but this year was really supposed to be different as going into the post-season they were heavily favored to finally win a Pennant (they had swept the Mets in seven regular season games), and ride the late-season momentum to end the century-plus long wait for another World Series crown. Interestingly, the last time the Cubs were so heavily favored to win a World Series was in 1906 when they were playing their crosstown rivals, the Chicago White Sox. The Cubs had just completed the best season in the history of baseball, winning 116 games during the 154 game season for an astonishing 76.3% winning percentage (the 2001 Mariners tied the 116 wins, but lost 10 more games for 71.6%) and were facing a team known as the "Hitless Wonders" (.230 team batting average). The teams split the first four games, but then the White Sox exploded for 26 hits in the last two games and pulled off one of the greatest upsets in World Series history. In just one more ironic twist, the White Sox beat the Cubs on October 14, 1906 by the same score of 8-3 as the Mets beat them on BTTF Day this year.

1906 was a tumultuous year in the U.S. financial markets as the DJIA had peaked in January and had been locked in a modest correction for most of the year, exacerbated by the impact of the great San Francisco earthquake in

April. Stocks had fallen (18%) by summer, but had recovered half of the losses as the October baseball classic began. In July, the Hepburn Act had been passed which gave the Interstate Commerce Commission the right to regulate railroad pricing (sound eerily familiar to all the recent jawboning about drug price controls) and railroad stocks declined rapidly leading to another (17%) decline from September through March of 1907 (referred to as the Rich Man's Panic). Many stocks began to decline, but securities related to commodity related businesses fell even more rapidly as they had been used as collateral for lending by the rapidly expanding National Trust business. These non-Bank lenders had seen explosive growth in the early 1900s, fueled by prominent members of the New York financial circles who used the Trusts to expand leverage on their equity holdings. One trust in particular, Knickerbocker Trust, became the namesake of the Panic of 1907 (Knickerbocker Panic) that would nearly take down the U.S. financial system one year hence. Earlier in the 1906, Augustus Heinze (a copper magnate from Butte, Montana) had moved to NYC and formed a relationship with notorious banker Charles M. Morse. Heinze and his brother, Otto, had a plan to corner the copper market through their holding company, United Copper and went with Morse to Knickerbocker Trust in search of financing. Charles T. Barney (the son-in-law of famous financier William Collins Whitney) had built Knickerbocker to the 3rd largest Trust in NYC and developed broad relationships with operators like Morse and Heinze. Although Barney declined to lend into the Heinze brothers plan, Otto pushed ahead with the plan and began to buy shares in United Copper to try and squeeze the shorts. While the initial squeeze worked, unfortunately, Otto underestimated the depth of market and United stock turned down hard, falling from a peak of $60 to $10 from October 14th to the 16th and the Heinze brothers were wiped out.

The initial response to the collapse of United Copper was limited to the bankruptcy of a brokerage firm and a Montana bank controlled by the Heinze brothers, but slowly began to spread to banks and Trusts that had lent money to the scheme, or where the Heinzes or Morse had affiliations. These financial institutions began to experience "Runs" where depositors rushed to withdraw their money in fear of mounting losses, as the leveraged transactions were unwound. The contagion began to spread more quickly the following week and the Board of Knickerbocker Trust actually forced Barney to resign due to his associations with Morse and the Heinzes on October 18th and J.P. Morgan Bank pulled their support as clearing house resulting in a full-fledged bank run that forced Knickerbocker into insolvency. Over the course of the next few days a wave of Trust defaults occurred culminating in a run at the Trust Company of America and on October 22nd the president of the TCoA made a call to J.P. Morgan himself for help. Morgan conferred with the two other large banks in NYC and the Secretary of the Treasury and declared *"this is the place to stop the trouble then."* Morgan then convened the presidents of the remaining Trusts and organized a group of loans to shore up the balance sheet. The Treasury deposited $25 million into a number of banks and John D. Rockefeller deposited $10 million into National City Bank (today Citibank). Finally, Rockefeller (the richest man in America) called the Associated Press and issued a statement that he would pledge half his wealth to *"maintain America's credit."* However, despite the cash infusions, banks were reluctant to lend and the regional stock exchanges began to close as credit disappeared. The NYSE was on the verge of closure on October 24th when Morgan told Ransom Thomas that an early closure of the Exchange would be catastrophic and again summoned the bank presidents and raised $23 million in ten minutes to keep the NYSE open. One of the challenges at the time was that there was no Central Bank to infuse liquidity into the system so the Treasury and the City of New York had to step in to provide a backstop to restore confidence. With the New York Clearing House issuing $100 million of loan certificates for the banks to trade a sense of order was restored by the following week.

Unfortunately, while the Trust Panic had been quelled, there was imminent danger of a number of bankruptcies, primarily resulting from excessive lending by brokerage firms against commodity related businesses like Tennessee

Coal, Iron & Railroad Company. The economy had also slipped into a severe Recession in May of 1907 that would last into 1908 and the stock market fell (50%) from the peak in early 1906. During the last days of the crisis there were a number of events that led to a rapid consolidation of economic power across a small number of financial elite. After consolidating control of the remaining Trust companies in J.P. Morgan Bank, U.S. Steel (controlled by J.P. Morgan personally) was allowed to take over TC&I despite significant anti-trust concerns. As the crisis eased in the following year, Senator Nelson Aldrich, father-in-law of John D. Rockefeller, Jr., established and chaired a Federal Commission to investigate the causes of the Panic of 1907 and propose future solutions. Senator Aldrich spent two years traveling to Europe to study their Central Bank model and upon returning convened a secret meeting of the nation's leading financiers at the Jekyll Island Club in Georgia (ironic name for the hatching of what has become such a controversial institution) to help draft legislation that led to the creation of the Federal Reserve System. The report of the Commission was delivered in January 1911 and after nearly two years of heated debate in Congress the Federal Reserve Act was passed on December 23, 1913. Notably, during the process, J.P. Morgan was summoned to testify to the Pujo Committee in 1912, which was investigating the role of the "Money Trust" (the powerful group at the center of the Panic of 1907) and had the following conversation with special counsel Samuel Untermyer:

Untermyer: "Is not commercial credit based primarily upon money or property?"
Morgan: "No, sir. The first thing is character."
Untermyer: "Before money or property?"
Morgan: "Before money or anything else. Money cannot buy it. A man I do not trust could not get money from me on all the bonds in Christendom."

The essential message from this exchange is that financial systems are based on a very ephemeral thing, trust, and the loss of that trust can happen swiftly and have very significant consequences (we will come back to this construct later).

In the midst of all of the turmoil in financial markets in 1907 and the resulting economic malaise in 1908, baseball played on and the Cubs won back-to-back World Series Championships. One of St. Louis' most famous sons is Mark Twain who once quipped that *"history doesn't repeat, but it rhymes"* and the final link in our Six Degrees chain is the iconic Harry Caray who got his start in sports broadcasting with the St. Louis Cardinals in 1945, but is most remembered for his legendary final sixteen years as the announcer for the Chicago Cubs. I was fortunate to live in the Chicago suburbs during Harry's time with the Cubs so I got to experience his colorful commentary, his affinity for Budweiser (Cub Fan, Bud Man), his penchant for trying to say the multi-syllabic player names backwards and his truly extraordinary renditions of *Take Me Out To The Ballgame* during the Seventh Inning Stretch. For the latter, Harry would grab a hand held microphone, lean out the open window of the Press Box and belt out the all-American tune with unmatched vigor and style, imploring the crowd to turn up the volume of the "one, two, three strikes you're out" line. Where the linkage comes in is that Harry was a doppelganger for the subject of our letter, A.W. Jones, as the two white-haired, bespectacled gentlemen could easily be confused for twins.

We gave some brief background information about A.W. Jones in our Q1 letter titled, *Not Lyin', Big Tiger's a Bear, Oh My!* when writing *"the Father of the Hedge Fund was Alfred Winslow (A.W.) Jones. Jones was born in Australia, graduated from Harvard, was a U.S. diplomat and earned a PhD in Sociology from Columbia, before becoming a member of the editorial staff at Fortune magazine where he was inspired to try his hand at asset*

management while writing an article about current investment trends in 1948. He raised $100,000 (including $40,000 of his own money) and created a partnership that employed a long/short equity investment model where he combined leverage, and short selling of securities, as a means to control risk and produce more stable returns. In 1952, Jones converted the fund to a limited partnership and added a 20% incentive fee as compensation for the general partner. The hedge fund concept did not catch on until 1966 when Fortune ran an article entitled ***The Jones Nobody Keeps Up With****. That article showed that Jones's track record was superior to all listed mutual funds and had beaten them by double digits in the past year and by high double digits over the past five years. Importantly, the article pointed out that the strategy was profitable in most Bear markets, including only a small loss in 1962 and that Jones himself had become rich as the manager."* The 1966 Fortune article was written by Carol J. Loomis who would go on to an amazing 60 year career at the magazine and eventually become the most successful (as measured by awards and prizes) financial journalist in history (as a side note, she would also become close friends with Warren Buffett, and has been the long-time editor of his Annual Letters). Ms. Loomis' opening line summarizes the performance of the partnerships at A.W. Jones & Co. *"There are reasons to believe that the best professional money manager of investors' money these days is a quiet-spoken seldom photographed man named Alfred Winslow Jones."* The article actually coined the term "hedge fund" to describe Jones' funds (although she lost the "D" as Jones called his original partnership a Hedged Fund), she pointed out that his partnerships had outperformed the best performing mutual fund, the Fidelity Trend Fund, over the previous five years by 44%, despite the drag of the incentive fee structure. Over ten years the results were even better, having bested the top performing Dreyfus Fund by 87%. Unsurprisingly, the publishing of "Jones' Big Jumps" (as the performance was labeled in the article) led to a flurry of interest in hedge funds and the creation of about 150 new funds in the next few years including funds run by legendary investors George Soros and Michael Steinhardt. Some observers (including us) would say that this article was the initial catalytic event that led to the hedge fund boom that has occurred over the past fifty years.

Jones was a very private person and eschewed the spotlight, so there is not a lot of information in the public domain beyond the two key Fortune articles and a reasonably large number of profiles of Jones that hedge fund industry people have written over the years (like this one). It has been written that the idea to start his original "Hedged Fund" came to him after writing the article *Fashions in Forecasting* for Fortune. He concluded from his research during the process that he had about as many good ideas on the markets as the people he interviewed for the story so he should take the leap and become a portfolio manager. Given that this would be his fourth career, and that he was beginning his new enterprise at the age of 48, he was quoted as saying ***"With a wife and two children, I needed something more lucrative, and turned to Wall Street."*** One of the conclusions from his forecasting article research was that market direction could not be reliably forecasted, but individual companies could be reliably analyzed. The data is very conclusive here on the difficulties of market timing for the average investor. Take the last twenty years of mutual fund and individual investor returns (from the Dalbar study) as evidence of this conclusion. Over the past two decades an investor could have made 8% compounded annually simply by buying, and holding, equity index funds. Over the same period, an investor could have made 6.5% by buying, and holding, bond index funds. Unfortunately, the average investor constantly chased the hot performing asset class and through a series of ill-timed moves only managed to earn 3.5%, which is, in a word, awful (even a simple 50/50 blend made 7.25%). Jones said, ***"The logic of the idea was very clear. It was a hedge against the vagaries of the market. You can buy more good stocks without taking as much risk as someone who merely buys."*** The average investor hedges those vagaries by reducing exposure to equities in their portfolio, either Structurally (moving to a 60/40 or 70/30 stock/bond mix), or Tactically (opportunistically shifting stock/bond mix or going to cash) and both strategies have historically resulted in returns that were lower than equities (a

mathematical certainty in the absence of market timing skill). Risk, as measured by standard deviation, was usually reduced, but at the expense of meaningfully lower long-term returns. Jones personal perspective on risk and reward came through clearly when he told a reporter that the firm could probably have made a great deal more money than it already had ***"by being way out long"*** but that would have been ***"an imprudent policy. It would have been improper to do so because we are handling other people's money."***[1]

The true genius of the Jones Model, however, comes from the insight to combine leverage and hedging, using borrowed funds to increase the total long exposure to equities and reduce the risk of the portfolio through selling securities short. We wrote last quarter of another very wise man who realized the same thing about reducing risk, saying *"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 in the eighth wonder of the world."* In a true Jones Model portfolio, the investor starts with $100 of equity, borrows $50 on margin to take total long equity exposure to $150 and then shorts $100 worth of stocks to take total Gross exposure to 250%, but the hedging reduces Net exposure back to 50% (150% long – 100% short = 50% net). Jones view was that to be successful ***"the fund's capital must be both leveraged and hedged. The leverage arises from the fund's use of margin, while the hedge was provided by short positions"*** and it was critical to have both in place at all times. There is a huge structural advantage to always striving to make money on both sides, since no matter what the market environment, there are always some stocks that are rising and other stocks that are falling. Whereas a traditional equity investor must sit idly and absorb losses during a market downturn, or worse, sit and hope for a market upturn (remember that hope is not an investment strategy, in investing, it is a four letter word), the Jones Model strategy is able to remain fully invested in all market environments and extract returns from both rising and falling stocks. Jones summed it up best when he said ***"hedging, was a speculative tool used for conservative purposes. Without it, I would not have been able to sleep so well at night."*** Given his experience in writing the article on market timing techniques not being reliable, Jones created a model that protects the portfolio in the event that one misjudges the general direction of the markets. Perhaps one of the least understood (but most important) elements of the Jones Model is that investors can be more aggressive with the stocks they buy because of the safety net provided by the hedged position. Similarly, the hedged structure allows investors to press winners, both long and short, to take advantage of the Reflexive nature of price momentum. Jim Grant made a very interesting observation in an article in 1998 about *The Missing "D"* in saying that, "*the model protects against overall market movement, but against psychology too, as one must find shorts in rising markets and find longs in falling markets!"* This insight harkens back to last quarter's letter when we wrote about John Burbank saying *"Price is a Liar"* and that most of the best investment opportunities come from taking the opposite view of the current price of a security and remaining rooted in the fundamentals.

The Jones Model's unique combination of leverage and short-selling to hedge the portfolio does indeed reduce the risk of the portfolio related to market directionality, but risk is like energy, it cannot be eliminated, it can only be changed in form (like heat energy can become light energy). By increasing the overall Gross exposure of the portfolio to 250%, there is a significant increase in the security specific risk in the portfolio, essentially swapping Beta (market risk) for Alpha (idiosyncratic risk). Therefore, the biggest challenge for a hedge fund is to buy stocks that will perform better than the general market and sell stocks that will perform less well or, better yet, will

1) http://www.awjones.com/images/II_-_The_Long_and_Short_of_the_Founding_Father.pdf

actually fall. If the manager is successful in selecting superior securities, the rewards are multiplied dramatically because more than the entire original capital is exposed to equities. An important perspective is that the ***"secret of success is the ability to get good information about stocks and be able to act on it quickly."*** Better information leads to better analysis and higher conviction, which give the manager confidence to move in and out of stocks more frequently than traditional funds. Jones found that they had a capacity to get a consistent flow of good, fresh ideas about stocks from brokers because they allocated a generous portion of their commissions to smaller, more research intensive brokerage firms. One everpresent challenge, however, was that given the long-term upward bias of equity markets, it was always difficult to find good short ideas. Wall Street analysts have always had a natural bias toward long ideas (turns out positive analyst recs produce more I-banking business) and therefore it was up to the Jonesmen (the team at A.W. Jones) to generate short ideas and said they ***"consider themselves lucky to break even on shorts."*** Years ago Julian Robertson explained this sentiment (that he took from A.W. originally) to me in saying that given the greater upside potential of a long (infinite upside), sometimes the best short simply finances a better long.

John Burbank recently gave me a great line in saying that *"a portfolio manager has three voices, a fundamental voice, a technical voice and a risk management voice."* Jones would likely agree, and while he was very focused on fundamental stock picking, he developed some very important risk management perspectives that were far ahead of their time given that there was no Modern Portfolio Theory and no computers to calculate Betas and Correlations. In the introduction to the A.W. Jones reporting system it says, ***"It now must be made clear that such a program cannot be put into operation without careful and continuous controls. We have developed methods which provide accurate measurement of the degree of risk being taken at all times as well as a system of allocation by which we determine whether our gains or losses are attributable to stock selection or to the trend of the market."*** Jones created a concept called *"Separation"* to distinguish the risk of an individual position from that of the market (what is now referred to as Alpha and Beta). Anticipating the core elements that what would evolve into MPT is impressive enough, but the Jones construct of *"Relative Velocity"* was one of the most critical elements they developed, and is consistently overlooked by most managers (then and now) who practice long/short investing. To summarize, they wrote, ***"different stocks habitually move up and down at different rates of speed, and hedging $1,000 worth of a stodgy stock against $1,000 worth of a fast mover would give no true balance of risk. We must therefore compute the velocity of all our stocks, both long and short, by their past performance, compared with the past performance of a good measure of the market as a whole."*** So many overlook this critical concept and think that a dollar long and a dollar short result in a market neutral portfolio position which might be appropriate if the two stocks are KO and PEP, but not if they are PG and TSLA. Importantly, the calculation of Relative Velocity was not part of the fundamental analysis of the stocks and was not used as a determinant of their relative attractiveness, but rather in determining the optimal hedges from a risk management perspective as follows, ***"It must be pointed out that relative velocity has nothing directly to do with the desirability of a stock. All a velocity measurement does for us is to measure one aspect of the risk we are taking when we buy it or sell it short."***

One question that naturally arises from the strong performance of the Jones Model Hedged Fund is why doesn't everyone try to keep up with the Joneses? Perhaps, the premise that combining two things that are inherently risky on their own, leverage and short selling, can actually reduce risk simply generates too much cognitive dissonance for some. Jones commented on another misperception of risk in the article, saying that ***"an illusion is that short-selling is somehow more dangerous than buying a stock for a price. A stock can go up to infinity and down only to zero. There is no danger that cannot be provided for by adequate diversification."*** For the same

reason that an investor would be unlikely to buy a single stock as their total portfolio as the risk of ruin would be too great since individual stocks do go to zero, they would be equally unlikely to short a single stock as the risk of ruin would be even greater as you can lose more than the original invested capital. That said, movements in securities rarely happen in asymptotic fashion and a good risk management system would limit losses even in these extreme scenarios. A prudent investor would limit exposure to any one specific stock (long or short) as the idiosyncratic risks would be too high and diversification would indeed reduce the danger. Additionally, given the imbalance of risks of longs and shorts most managers size their max longs larger than their max shorts and would tend to have more shorts than longs, thereby naturally reducing the risk of the overall portfolio. Jones also makes the point that ***"Some people are not congenitally equipped to sell short. It goes against their psychological makeup."*** Most people are optimistic by nature and they want to focus on companies with positive stories, rapid growth, expanding profits and rising stock prices. Who wants to traffic in companies with bad business models, shrinking markets, declining profits and falling stock prices? Investors who want to play in a less crowded sandbox and have a greater ability to gain an analytical edge, that's who. In reflecting on the challenges of short selling, Jones said ***"I have never known a speculator who sold short and didn't hope to make money on it. That said, we hope to lose less on our shorts than we make in offsetting long stocks."*** Jones was consistent in his belief that it was the overall model that was the edge, not any one component, or single trade on either the long or short side. While they strived to find great businesses to buy and bad businesses to short, in the end the math favors owning more great companies than the original capital could have afforded by financing them with the proceeds of the short portfolio. An interesting question raised in the article was *"isn't there a danger of becoming so preoccupied with selling short that buying opportunities are missed?"* to which Jones provided one of his greatest insights (which we can corroborate from working with many of the world's greatest equity managers over the decades) ***"something else has emerged, people who learn how to sell short seem to have better judgment on what stocks to buy."*** The data here is incontrovertible. The greatest long-term track records in the business belong to practitioners of the Jones Model art of portfolio management.

Perhaps the most innovative, and also perhaps the most controversial, aspect of the original A.W. Jones partnerships was that the compensation structure was completely unique at the time and broke precedent in an industry dominated by fixed management fees. When Jones started the original Hedged Fund he decided he would take no management fee, but would take 20% of profits of the Fund. He said the arrived at the structure ***"modeled on Phoenician Sailors who kept one fifth of bounty from successful voyages"*** and felt that the incentive compensation structure aligned the interests of manager and investor. Clearly there is a strong motivational dynamic in the Jones Model Fund that strikes to the heart of the capitalist instincts of both managers and investors. Unlike in the traditional asset management world where the manager in incented to gather assets (higher AUM = higher fees) the hedge fund manager is motivated by large incentives to generate superior performance, counterbalanced by significant personal risk of loss since in the absence of performance there is no compensation. Jones had a very simple idea that the lure of 20% of the profits of the Fund would enable him to attract aggressive, capable young professionals into the firm. He believed that ***"success is not in the system itself, but in the talent and prudence of people managing it"*** and he created a structure, process and culture that increased the likelihood that he would have the best of the best working for A.W. Jones. Obviously each team member brings his own experience and personality to bear on portfolio decisions and therefore adding diversity of thought was important to Jones. The firm found new talent by actively identifying candidates with skills/expertise they believed would be beneficial to the firm and then gave them a test. Each candidate was given a paper portfolio to manage, if they did well they may get a small allocation of capital as a further test of how they operated using the Jones hedged model. If they performed well, they could be hired. The firm ran as a simple Meritocracy, those who performed

got more capital to manage, those that didn't simply didn't get any more capital. The process was best summarized as ***"give segments of the portfolio to the best and brightest on team. Pit them against each other and have the least successful move on to other pursuits."*** Competition drives outstanding performance and the competition was fierce at A.W. Jones.

In interviewing those who had worked for Jones over the years (many were quite successful and left to start their own funds), Loomis found that they stressed the fact that ***"there is no magic formula for making money with a fund operated on the hedged principle. Perhaps more than most kinds of investment management it depends on the brainpower of those who run the show."*** While the Jones Model of long/short management had a number of advantages over traditional long-only approaches that we have discussed above, in the absence of Alpha (excess returns resulting from superior analysis and security selection) there was nothing special about the investment strategy that would generate superior returns. As one Jonesman said ***"The marionette always works, it's the puppeteer who changes."*** Jones was very diligent in his selection of associates to work on his team and there were a set of personal characteristics that he required in order to join the firm and that he believed provided the highest likelihood of success within the organization. His core criteria were as follows, ***"a money manager must have an interesting set of abilities; vitality, aggressiveness and good judgment."*** However, Jones went further and stressed the fact that a successful manager must possess two sets of balances; ***"first, a balance between boldness and caution, and second a blend of gullibility and skepticism."*** A great manager must be confident and decisive and have a fearlessness that comes from superior preparation, flexibility and resiliency (ability to learn from mistakes and bounce back from setbacks), but those traits must be tempered by a cautiousness based on respect for risk and the knowledge of the vulnerabilities of any thesis (no matter how well researched). Jones explains that because a ***"money manager doesn't dream up ideas, he gathers ideas from other sources"*** they do indeed have to be intelligent, but what really matters is having a strong network from which to source ideas and the ability to sift through huge volumes of information to distinguish between the great ideas and the bad ideas. His point is that a truly great manager has the gullibility to believe in the ideas of others, tempered by the skepticism to question the core thesis behind each idea and to truly consider the source from all angles in determining the ultimate value of each idea to the portfolio. Additionally, Jones says a successful manager must be attuned to the latest fads and ***"must know what is coming into vogue, into fashion, because that is what they want to have."*** This construct is often attributed to Peter Lynch who said he often invested based on what his wife and daughter bought at the mall, but once again, it turns out that investing is all about keeping up with the Joneses.

We will repeat the second half of our intro to A.W. Jones from the Q1 letter here as it leads us to the follow up article written by Carol Loomis for Fortune four years hence, *"Suddenly, by 1968, some 150 hedge funds had been started, as many high profile investors were attracted to the lucrative compensation structure. However, in an effort to maximize returns, many managers turned away from Jones' original "hedged" strategy (the original fund name ended with a "d") and chose instead to simply add leverage to long positions. This long biased positioning led to heavy losses in the downturn in 1969-70 and many funds never recovered and were forced to close during the Bear market of 1973-74. It has been estimated that 85% of the original hedge funds shut down during this period and the nascent industry was in a serious crisis. Even famed investor Warren Buffet shut down his investment partnership in 1969 to "pursue other interests" (turned out alright for him…). At the time, there were cries for more regulation of the industry, higher taxation on the incentive compensation structure and greater oversight by the SEC (which sounds eerily similar to today). With just a few handfuls of hedge funds left in the market and total assets estimated to have fallen to less than $1 billion, it seemed prophetic that Fortune had written another article*

in 1970 entitled ***Hard Times Come to the Hedge Funds.***"
In talking with Jones, he said, ***"the trouble began in the 1966-68 period when the craze for performance swept the investment world and when all sorts of money managers, including those in our own shop, got overconfident about their ability to make money."*** Perhaps the confidence was somewhat warranted as A.W. Jones' record during the period, the three fiscal years from 1966 to 1968, was excellent as limited partners enjoyed net returns of 29%, 22%, and 45%, far superior to the market averages. Even Jones admitted to being caught up in the "euphoria" of the times as the Nifty Fifty soared to new heights every day. In a turn of phrase that was nearly heretical, Jones said ***"I began to wonder whether our hedging strategies, which had always been aimed at softening the effects of a potential market decline, but which held back our gains in bull markets, might not have been misguided; perhaps it would have been smarter to have run at full risk all the time, thus taking maximum advantage of the general upward trend of the market."*** Another manager referenced in the article, John Hartwell (who worked for a time for Jones), whose short-selling experience was quite extensive, summed up the challenge of being a hedged equity manager in a runaway bull market in saying ***"hedging is vastly overrated as a concept. People argue that there is psychological comfort in having a short position. I used to believe it, but I don't any more. I stopped believing it after we got bloody and beaten from short selling."*** There is nothing new under the sun and these words could have easily been written in the past week reflecting on the challenges faced by short-sellers over the past few years in the age of QE. In a final ironic (and again, comical, with the benefit of hindsight) comment, Jones was asked what lay ahead for hedge funds and said in a defeated tone ***"I don't believe it is ever going to become a big part of the investment scene, as it was in the late 1960s. The hedge fund doesn't have a terrific future"*** proving once again that Jones' forecasting abilities left something to be desired.

The seduction of the strong bull market took hold and Jones wrote a letter to investors that summer saying that going forward ***"his funds will not in the future be trying for the big swings, but will instead aim for moderate, steady growth*** (almost comically, moderate to Jones meant 20% a year). He went further in explaining that ***"each money manager is now fully aware of the necessity of running his segment as though the typical Limited Partner were retired and had all of his capital, say $500,000, invested in our business."*** The irony of the last part of the statement is that many of Jones' original investors who have given him a few tens of thousands of dollars did indeed now have half a million dollars and they were in a different risk/reward frame of mind. From the beginning, A.W. Jones' investors were an unusual blend of businessmen, writers, teachers, scholars, social workers and medical researchers. The unique thing about Jones, and many of his investors, is what the money itself meant to them. Jones said frankly ***"I wanted to make money on Wall Street in order to slope away from business and pick up my old interest in social affairs. Too many men don't want to do something after they make money. They just go on and make a lot more money."*** Jones was different. He wanted his limited partners, many of whom were active in scientific and artistic fields, to be free from financial worries so they could devote themselves entirely to their creative efforts. He was driven to perform at the highest level, to generate the highest returns to help achieve others have the freedom to pursue their higher purposes.

Alfred Winslow Jones is pictured above while on a vacation in Mexico City and with his flowing white hair and signature black glasses you expect him to start singing *Take Me Out To The Ballgame* any moment as he is truly the spitting image of Harry Caray; one degree. Harry Caray was the beloved voice of the Chicago Cubs (ironic bear imagery considering balance of this section) who last won back to back World Series Championships in 1907 and 1908; two degrees. The Recession of 1907 and 1908 that led to a significant decline in equity markets and catalyzed

the creation of the Federal Reserve was triggered by the Knickerbocker Panic of 1907; three degrees. The Panic of 1907 was caused by a loss of confidence in the financial system because of rapid deleveraging triggered by a failed attempt by the Heinze brothers to corner the copper market and excessive Bank and Trust lending to the commodities industry; four degrees. The Panic of 1907 was quelled when J.P. Morgan recapitalized the Banks and Trusts and urged Americans to remain calm by saying, *"If people will keep their money in the banks, everything will be all right"*; five degrees. In the final scene of *Animal House,* Kevin Bacon's character urges the panicking Faber crowd to *"Remain calm, all is well"*; six degrees. So there we have it, Six Degrees of Kevin Bacon. Remaining calm is easy when everything is going well, but significantly less so when things begin to deteriorate and what our little trip back in history shows us that once confidence is lost, things can deteriorate in a hurry. In the investment world gains tend to happen slowly and losses tend to happen quickly, the average bull market is much longer than the average bear market (about five times longer at 97 months versus 18 months). So how does one remain calm in the markets? A.W. Jones was right you sleep well at night by hedging. Jones proved over time (and many great hedge fund managers continue to prove) that the hedged (with the D) fund model was a far superior strategy for protecting and growing wealth. Given that the average bear market sees a decline of (40%) it becomes even more important to be hedged when the market environment heads in the bearish direction. The trick is determining when that period emerges and the good news is that there are myriad indicators that can help us identify the best time to increase our hedged posture. We will make the case that the time is now with a not so short list of reasons to embrace the wisdom of Mr. Jones.

How do we worry about the current equity market environment? Let us count the ways: Here are the *Not So Nifty Fifty* reasons why it is time to get hedged.

1. Welcome to the *New Abnormal.* We coined this phrase a few years ago as we thought there was nothing normal about the equity market environment since the extremes of 2000. From 1983 to 1999 the MSCI World Index almost never went down (2/17 of the years), compounded at 14.8% and the intra-year drawdowns were a manageable (10.5%). From 2000 to 2015 the World Index has gone down a lot (one third of the years) and has only compounded at 3.5% while experiencing average drawdowns of a gut wrenching (17.3%).
2. Post-Crisis Deleveragings are measured in decades. There have been four great unwinds, the U.S. in 1873, the U.S. in 1929 (there's that year again), Japan in 1989, and the U.S. since the 2008 trough and it takes 14 years on average to reach trough long-term interest rates which tend to settle between 1.5% to 2%. We are currently in year nine, so 2020 looks like the trough.
3. Global Trade has been flat since 2008 and is declining at an accelerating rate. Low levels of global exports have historically indicated imminent global Recession.
4. Industrial Production always turns down ahead of Recessions and has now declined for nine consecutive months. We have never had six consecutive monthly declines without having a Recession follow.
5. Even if a 2016 Recession were a shallow one like 2001 (two slightly negative quarters that weren't even consecutive) the market impact would likely be significant given where valuations are and the average correction in a Recession is (38%).
6. ISM ticked down again in October to 50.1 and is inching toward the contractionary sub-50 level.
7. Leading Economic Indicators have been declining and point to the ISM dropping below 50.
8. Q3 GDP rolling over to 1.5% (likely will be revised even lower) points to a sub-50 ISM.
9. Regional Fed Surveys have been terrible and are now all pointing to a sub-50 ISM.
10. S&P EPS and Cash Flow growth rates have turned negative which points to ISM below 50.
11. The Durable Goods Orders growth rate has collapsed, pointing to an ISM as low as 40.

12. When S&P 500 EPS peak and begin to decline (as they did in Q3) a Recession usually follows within a year.
13. Consumer Confidence has rolled over to levels that look quite Recessionary.
14. Retail Sales growth is trending down at an accelerating pace toward Recessionary levels.
15. There is no Inflation anywhere and both CPI and PCE are well below the Fed target of 2%.
16. PPI is at levels only seen in the depth of the Global Financial Crisis.
17. U.S. GDP is weakening very dramatically with Q4 trending at sub-1% today according to the Atlanta Fed GDP Now indicator.
18. Increasing Inventory levels could become problematic and have historically been a Recession trigger as the inventory cycle turns from destocking to restocking.
19. Forward Inflation Expectations (5 yr./5 yr.) are well below previous levels where QE was triggered (in sharp contrast to the jawboning about raising rates today).
20. Long Bond rates are signaling that Deflation is a much larger risk than Inflation.
21. History actually indicates that Fed should raise Fed Funds to 3% now (historically FF equals nominal GDP growth rate), but Fed has never raised rates when the PCE is below 2%, like today.
22. Contrary to popular belief, the Fed has not eradicated the Business Cycle (that might be the fat man, Harry Caray, singing for the 7th inning stretch…).
23. Fed tried to leave ZIRP (Zero Interest Rate Policy) too early in 1937 and we had a bad outcome. There is actually a case to be made that the Fed has lost control and there is no way out, just like in the 1930s.
24. When the Fed is not expanding the Balance Sheet, U.S. equities have struggled (actually made no return) over the past four years. With no more QE, where will equity return come from?
25. Is it possible that faith in the global Central Banks is waning? European and Japanese stocks have given back much of the gains triggered by last rounds of QE and QQE.
26. U.S. equities have reached extreme levels of valuation at 77% above their long-term regression.
27. U.S. equity P/E and adjusted P/E ratios are the third highest they have ever been.
28. The Buffett Indicator of the ratio of Market Cap/GDP is second highest ever, only worse in 2000.
29. The Q Ratio (valuation vs. replacement cost of corporate assets) is near record levels.
30. Margin Debt (the rocket fuel for the rally since 2009) has begun to roll over (down 11%) and when it turns down it tends to decline very sharply and rapidly leading stocks lower.
31. Inflation Expectations levels have historically been highly correlated with forward P/E ratios and the collapse in inflation expectations argues for much lower equity multiples (down 40%).
32. GMO Forecasts poor returns for traditional assets over the next seven years including an approximately 1% nominal compound annual return for U.S. equities.
33. Another longer-term equity model used by a number of asset managers (created by Butler-Philbrick) also predicts a slightly negative return for U.S. equities over the next decade.
34. A recent Barron's Cover could be an example of Front Page Syndrome. When comparing the current move in equities to the move from 1995 to 2000, the current rally should be ending around now at around current levels (welcome to 2000 2.0).
35. The Strategas Equity Trend Model turned negative recently, just like it did in 2000 and 2008.
36. Market Crises are highly correlated with Dollar surges like the one we have just experienced over the past year. Question is whether we're more likely to see an environment like 1998, 2000 or 2008?
37. Equity market cycle highs usually occur in Q4 of the 4th year of the Presidential Cycle (now) and cycle lows usually occur in Q1 of the 1st year (Q1 2016) or the Q2 of the 2nd year (Q2 2017) which aligns nicely with the 2000 2.0 playbook of a Recession in 2016 and market trough in 2017 matching up nicely with the 2001 to 2002 period.

38. Small-cap weakness (lagging large-caps in Q3) is a sign of deteriorating market fundamentals.
39. There is huge dispersion in valuation and margins across equity market sectors, which has historically been a target rich environment for long/short investing.
40. The current equity market advance is becoming increasingly narrow.
41. Only the largest Technology and Consumer companies are leading in the current rally.
42. The extreme of the narrowness can be seen in the Consumer sector where returns are completely dominated by three names (NFLX, EXPE, and AMZN) and rest of sector index is actually negative.
43. The trend in the Consumer sector has deteriorated dramatically in the past year and only two sub-segments still have positive momentum.
44. Energy sector fundamentals have absolutely collapsed and there is real risk of bankruptcies in the sector as overleveraged companies are shut off from additional capital.
45. The infamous Hillary Tweet caused one of the worst sector crashes ever recorded in the Healthcare sector showing how fragile equity markets are in the current environment.
46. Biotech in particular, is looking increasingly vulnerable to a valuation correction.
47. The Four Horsemen of the #Growthpocalypse (copper, Korea, oil, rates) are all pointing to slower growth and potentially lower stock prices. Dr. Copper has been looking sick which has normally been a leading indicator of slowing growth.
48. The KOSPI Index has been declining, which has historically been a good leading indicator of slowing growth in the U.S. (and lower equity prices) given high tech components weighting.
49. The collapse in oil prices over the last year correlates well to periods of slowing growth and potential deflation, which has historically been a challenging environment for equities.
50. The 10-year Treasury rate has been stubbornly low (in contrast to the predictions that they would rise above 3% by year end) which is a sign of deflation risk and slowing growth.

Last quarter, we wrote about the Gordian Knot, a legend linked to Alexander the Great which is often used as a metaphor for solving an intractable problem with a bold stroke. We wrote that *"Alexander was attempting to solve the problem and 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 loose it?" He then drew his sword, raised it above his head and with one powerful stroke severed the knot."* All those attempting to untie the Gordian Knot up to that point had used a traditional method of untying something, their hands and fingers, but given the complexity of the knot itself, they were unable to solve the problem. Many would say that Alexander's used an "outside the box" solution. We would observe that Alexander took a much different approach that he had learned from his great teacher, Aristotle, to think like there is no box. He realized that there was a superior approach, unloose rather than untie, a superior tool, his sword instead of his hands, and he literally used a bold stroke to create outstanding results. Alfred Winslow Jones took the same approach to solving an intractable problem in investing: outperforming the market on a consistent basis. Investors had tugged at that knot, so to speak, for decades with limited success as they were bound by the traditional construct that one should buy the good companies, avoid the bad companies and perhaps occasionally raise cash as a defense against a market downturn. A. W. Jones had an equivalent eureka moment to Alexander in studying the myriad ways that investors tried to create better forecasts about the direction of the market and he realized that a totally different approach was needed to produce truly superior results consistently regardless of the market environment. Jones effectively drew his sword and in one powerful stroke fundamentally changed the asset management business. By combining going long great companies and short bad companies he was able to use both edges of the sword and by using leverage he was able to lengthen the blade and gain more power.

Alexander the Great was never defeated in battle. A.W. Jones was undefeated in investing. He was indeed *The Jones Nobody Keeps Up With*. We wrote last time that *"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 great leaders the world has ever known."* Jones created those same edges in investing as he created a superior investment strategy and utilized tactics that allowed him to always fight from a position of strength. By always having hedging in the portfolio Jones was able to be more aggressive in his long positions and create truly superlative returns for his investors. Another significant edge that he created was the perfect alignment of interest of having his compensation directly tied to the success of the portfolio results. While the consequences for Jones of a failure in strategy or tactics were far less severe than Alexander (not life and death), there is an important element of raising the stakes to a level that enhances the focus and commitment when there is no remuneration if there are no profits. Simply stated, incentives work and they create edge. In closing the section on Alexander last time, we wrote *"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."* For all of the reasons we outlined above, we believe that these words ring even more true today. Long/Short investing strategies provide protection when you need it most and outperform most during stressful periods like 2000 and 2008. At this point we don't see things devolving into another Global Financial Crisis (but we reserve the right to change our minds if there is a Policy Error), but we do believe that we have entered a three-year period starting this past April that will resemble the period from April of 2000 to April of 2002. A. W. Jones was right. It is time to get hedged.

Third Quarter Review

Summertime is often a time for heading to the Amusement Park to spend some time eating great American foods like hot dogs and cotton candy, playing carnival games and riding the rides. Q3 was the embodiment of the proverbial roller coaster ride for global equity investors as fears about Greek Debt and Capital Controls, the PBOC's decision to weaken the RMB and the Fed's inability to communicate a cogent plan for beginning to raise the Fed Funds rate in the U.S. caused significant volatility in global equity markets. Looking at the numbers, the S&P 500 started the quarter at 2,063 and slowly climbed the coaster track to 2,128 on July 20th before careening down (12.2%) to trough at 1,868 on August 25th, then climbed the track again to 1,995 on September 16th before careening down again to 1,882 on September 28th (making a very nice technical Double Bottom) and has since surged 10.5% from there back to just about where it started four months ago. The Euro Coaster was even scarier as the Euro Stoxx 50 started the quarter at 3,424 and climbed a swift 7.7% to 3,687 by July 20th before plunging (16.7%) to 3,073 by August 24th, jumped a quick 6.7% over three days before careening back down (8%) to 3,019 by September 24th and has since surged 13.2% back to where it began four months ago. The Japanese version of the roller coaster was even more extreme as the Nikkei began the quarter at 20,236 and crept up the track to 20,841 by July 21st before screaming downward (14.6%) over the next month to August 25th, surging 7.5% over the next three days, then careening down (9%) through September 8th. It then surged 7.7% in one day on September 9th (the eighth largest one day move in history), dropped another (9.8%) over the rest of September and has since climbed back to 19,083 through the end of October (still down (8.4%) from four months ago). However, the scariest ride award goes to Emerging Markets where EEM began the quarter at 39.6 and immediately started careening downward, dropping (7%) by July 8th, took a little track ride back up 5.4% by July 16th and then zoomed down the monster hill, falling (19.3%) to the bottom on August 24th, surged 10.5% over three weeks to September 16th before dropping another (8.4%) to bottom again on September 28th and finished the quarter down (17.9%). There has been a strong rally in EM in October, up 8.5% from the trough, but still down (10.1%) from four months ago.

One of the things we have discussed in previous letters is how there has been a strong correlation between Central Bank QE bond purchases and subsequent increases in equity markets. We have seen this movie play out in the U.S., Japan and most recently Europe as the ECB finally found a way to make QE work across the Eurozone. Writing about the U.S. equity markets, we had referenced on numerous occasions some work done by Larry Jeddeloh at TIS Group that showed, "*historically every $100 billion of QE has translated into Forty S&P 500 points*" and noted that equation had been very prescient in determining the likely rise in stocks during the Fed's Long Term Asset Purchase Operations. A year ago when Ms. Yellen said that the Fed would cease the QE Program in the U.S. we asked an important question in our Q4 2014 letter, *"Given U.S. equity markets have been driven by the QE equation since 2009, the cessation of QE this month does beg the question of what happens in 2015? 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?"* When forced to face the stark reality of market valuations in the U.S., where every valuation indicator for the S&P 500 including Yield, P/B, Market Cap/GDP, CAPE Ratio, Tobin's Q and P/E Ratio are at levels exceeded only by the ludicrous levels of the 2000 Tech Bubble, it was difficult to make a case for continued strength in domestic stocks. We wrote two quarters ago that, *"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?"* With the Q3 results in and seeing the S&P 500 down (6.4%) and the Russell 2000 down (11.9%), it appears that we have an answer: they won't. With the

dismal showing in the third quarter tacked onto markets that were essentially flat in the first half, the S&P 500 now stands down (5.3%) for the CYTD and the small-caps are even worse off, down (7.7%). While there are still a couple of months to go in 2015 (and October saw a solid 8.4% rally that brought the S&P 500 back into slightly positive territory) we reiterate again what we wrote in January in our MCCM Ten Surprises List (Surprise #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 announcement back in January that the ECB would be taking the QE baton from the Fed in 2015 there had been a huge "front-running" rally in European equities in Q1 with the MSCI Europe Index surging 16.6% in Euros. The challenge for U.S. investors is that if you didn't hedge the currency, the return fell to a much less exciting 3.5% as the Euro was pounded by Draghi's commitment to QE. We correctly anticipated in the Q1 letter that "*it would make sense to see a pause that refreshes in the short-term in Europe"* and Q2 was less exciting as the Index shed (3.3%) in Euros, but further weakening of the currency against the Dollar offset losses for investors who hedged and the return switched to a modest gain of 0.4%. We went further in that letter saying, *"the infamous admonition of "Don't fight the Fed" can clearly be modified here to "Don't fight the ECB" in the coming year,"* however the ECB version of QE has not played out as well as the U.S. version and European equities were caught in the global roller coaster ride in Q3, falling (8.7%). The Euro was relatively stable during the quarter as well, so the returns in USD were fairly similar, down (8.9%). We wrote last quarter about the idea that there could be a similar relationship between European equity market returns and ECB QE activities. Looking at the data from the first few months of the Program, we attempted to quantify the exact relationship saying, *"the European Central Banks have purchased $240B of bonds and the Euro Stoxx 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."* Clearly there has been a slip between the ECB QE and the Euro Stoxx 50 Index during Q3 and even with the strong rally in October, we would need to see a little more than a 15% move over the next two months to achieve the 3960 target by year end. Santa Claus rallies of that magnitude are not unheard of and in talking to some European managers on a recent trip to London there was serious bullishness about European equities, so it will be interesting to watch these markets in the weeks ahead.

In Q3, Japan's BOJ chief, Haruhiko Kurodo, seemingly lost his grip on the QE baton and the market which we had begun to refer to as the *"Land of the Rising Stocks"* struggled mightily and the MSCI Japan Index fell (11.8%) and gave back nearly all of the gains from the first half, finishing us a scant 0.2% for the CYTD. We wrote in the Q1 letter 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."* Unfortunately in Q3 the impact of rapidly declining oil prices pushed Japanese CPI back well under the 2% target and economic growth slid back toward recession levels. There wasn't all bad news, as corporate earnings continued to surge to new record levels, but foreign investors didn't seem to care about rising profits as they sold in droves (even as Japanese pension funds continued to buy) and asset price increases took a pause. We have been writing about the Japanese banks for a while and we wrote last quarter that they *"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, in Q2 (to bring CYTD returns to an even more impressive 27%, 34% and 34% respectively)."* What the markets gave in the summer, the markets took back in the fall as the Big Three Banks shed what they gained in the previous period, falling (14%), (16%) and (14%), respectively. We also wrote last quarter that, *"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 that absence did not go unnoticed in the third quarter. Investors became increasingly antsy for a sign from the BOJ that they would continue to fight the Global Currency Wars and sold with increasing vigor as Kuroda-san failed to brandish his light saber. The other countervailing challenge was that with global equity prices falling in Q3, the Yen emerged once again as a safe haven and actually strengthened 2.2%, putting more pressure on the BOJ to act. The good news is that with prices falling and EPS rising, valuations became increasingly compelling and there has been a noticeable jump in Japanese equity purchases in October (alongside the global equity rebound) and the Nikkei has bounced roughly 11% from the trough at the end of the quarter. We wrote in Q1 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 and the Nikkei could hit 22000."* At the halfway point those predictions looked achievable with the Yen at 123 and the Nikkei at 20236, but the slippage over the past four months leaves the Yen at 121 and the Nikkei at 19,083, so it likely would have taken another huge Halloween Treat from Kuroda-san at the next BOJ meeting (which we unfortunately didn't get…) to get the roller coaster car back on the track to reach those lofty levels.

Taking a deeper dive into the performance of the U.S. equity markets in Q3, despite the negative outcome for the overall market as measured by the S&P 500 Index, there were a small number of pockets of relative strength that are keeping hope alive for the equity Bulls. The Large-cap growth stocks continued to outperform the broader indices, falling only (4.1%) and the MSCI Minimum Volatility Index was down a scant (1.3%) as investors sought the safe havens of stable cash flow and higher yields. For the CYTD, both of these indices are nearly breakeven versus the (5.3%) loss in the S&P 500, down only (0.4%) and (0.6%), respectively. Another Bullish indicator for the markets in 2015 has been the total dominance of Growth versus Value as there are a handful of segments in the market that continue to generate solid earnings despite all the dire predictions of falling revenue growth and declining margins. Large-cap value fell more than twice as much as growth in the quarter, down (8.6%) and is down (9.5%) for the CYTD versus the nearly flat performance on the growth side. As you drop down in the capitalization spectrum the Growth/Value dynamic begins to change as mid-cap growth and value both fell (8%) and small-cap growth was down (13.1%) versus small-cap value down (10.7%). For the CYTD, growth is still beating value handily, (4.2%) to (7.7%) in mid-cap and (5.5%) to (10.1%) in small-cap. Looking at the performance of the sectors of the S&P 500, the dispersion during Q3 was as wide as it has been in many years as there was complete decimation in the Energy & Materials sectors and a mad rush to quality in the Utilities & Staples sectors. Four sectors outperformed the markets, Utilities were the lone positive sector, up 5.4%, Staples were nearly flat, down (0.2%), Consumer Discretionary was down only (2.6%) and Technology fell only (3.7%). Five sectors trailed the Index as Financials fell (6.7%), Industrials dropped (6.9%), Healthcare was down a surprising (10.7%), (mostly caused by Hillary Clinton's vote pandering tweet about wanting to rekindle her 1994 crusade against drug prices), but the real damage was in the Materials and Energy sectors which tumbled an astonishing (16.9%) and (17.4%), respectively. For the CYTD, the sector data aggregates to a profile of a very tired Bull Market with only Consumer Discretionary up, rising 4.1%, the defensive sectors of Staples, Healthcare and Technology down (1.0%), (2.1%) and (3.1%), respectively, and the commodity related sectors like Industrials, Materials and Energy lagging badly, down (9.8%), (16.5%) and (21.3%), respectively.

The U.S. Dollar seems to have settled down a bit since

the huge 9% surge in DXY in Q1. After surrendering (2.5%) of that gain in Q2, surprisingly the USD mostly marked time in Q3, finishing up just 0.8%. We say surprisingly, because after peaking in mid-March, the talk about King Dollar reached a fevered pitch in Q3, as everyone was certain that the Fed would raise rates in September and Emerging Markets currencies were pummeled during the period. That talk has certainly faded and with the lack of Fed follow through on raising interest rates (and the obsession with the rising Dollar in the Fed minutes) the momentum in USD has clearly shifted. International markets were clobbered in Q3 and the results were bifurcated as the developed markets fell on global growth concerns and EM fell on currency markdowns. We have said since late last year 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. Looking at the international indices during the period, ACWI ex U.S. fell a stunning (12.2%), EAFE was off (10.2%), MSCI Europe was down (8.7%), MSCI Japan fell (11.8%) and the MSCI EM Index plunged a startling (17.9%). There was no place to hide in international equity markets as only Estonia managed to eke out a positive return (up 4%, but not liquid enough to matter). Returns ranged from merely bad to truly awful around the globe as investors hit the sell button hard in August. We had anticipated that there would be high levels of volatility and wrote in Q1 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 said, we had no idea the range of outcomes would be this wide and that the selling would be so broad based. In the developed markets there were a couple of places where losses were muted like Denmark, down (2.4%), Ireland, down (3.2%) and Italy, down (4.4%), but the core markets like Germany, France and Japan were down (10.9%), (6.5%) and (11.8%), respectively, and there was some real destruction in places like Hong Kong, down (16.2%) and Australia, down (15.3%) while Norway plunged (19.1%) as oil prices took their toll on commodity focused markets.

The range of outcomes was even wider in Emerging and Frontier Markets as equity market losses were compounded by massive currency losses in some countries. In EM, a handful of markets vied for the best of the worst award as Hungary fell only (3.3%), Czech Republic and Qatar dropped (6.6%) and India slipped (6.7%), but there was real carnage across the board with countries like UAE falling (10.4%), Korea dropping (11.8%) and Mexico falling (12.0%) while Russia dropped (14.8%), South Africa fell (18.6%), China plunged (22.7%), Brazil cratered (33.6%) and Greece brought up the rear, shedding (35.8%). While those losses were truly horrific, in many cases the damage was primarily currency related, so there was some reason to believe that those markets could turn just as quickly to the upside if there was a resolution to the Fed interest rate decision (there was and there has been a tremendous October rally in EM). Some examples are that the Rand was (13.2%) of the South Africa losses, the Ruble was (15.4%) of the Russia losses and the Real was (21.4%) of the Brazil losses. After the strong performance of EM in the first few months of 2015, the old adage of "Sell in May and go away" would have been great advice in emerging markets as they peaked in April 28th. We wrote last quarter how *"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."* Coincident with writing the last letter, we did an Around the World Webinar at the end of July entitled, Build Your House With BRICS: Why Emerging Markets Rule, and we made the case for beginning to think about investing in these markets again, saying that we could *"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." Little did we know that we were only a few weeks away from that cathartic surge in pessimism as the EM Index plunged (15.6%) in the next four weeks to bottom on August 24th, down (27%) from their April high. With the Fed decision not to raise interest rates, there has been a fairly robust rally in emerging markets over the past eight weeks (much of it, but not all of it, from short covering) and the Index finished October 10% higher than the nadir (but still down (9.5%) CYTD).

Frontier Markets also had a challenging Q3 as the MSCI FM Index fell (10.6%) and the range of outcomes across the countries was quite wide. Some of the Eastern European markets like Serbia, Lithuania and Romania suffered only small losses of (2.4%), (2.0%) and (0.1%) respectively, while Middle Eastern Markets like Oman, Kuwait and Bahrain fell (7.0%), (8.4%) and (13.4%) respectively. Returns in Africa were mixed as Nigeria managed to only be down (6.4%), while Kenya was down twice as much, falling (12.8%). Some of the larger markets like Pakistan, Saudi Arabia and Argentina saw much larger losses, falling (13.3%), (16.2%) and (26.7%), respectively, as the higher liquidity in these markets allowed global investors to repatriate capital more easily as the global market correction intensified in August. We wrote last quarter how *"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. The Saudi market has indeed been solid all year (in anticipation of the move) finishing up 11.9% for the first half of 2015,"* but investors were quick to revert back to the Saudi is an Oil Market story (despite the oil assets being owned by the government) and as oil prices collapsed, Saudi equities followed. In talking with managers a few weeks ago in London about the Saudi markets, they continued to be positive about the Consumer story and believe that the opening up of the markets to foreign investors will continue to provide a tailwind for Saudi equities. We also wrote last quarter how *"Argentina has been one of our favorite markets since early 2014. Unfortunately, the holdout issue was not resolved and speculation is that now it will not be settled until after the election. We continue to see tremendous opportunity in Argentina, believing it will be one of the best performing markets over the coming year."* We were pleased by the surprising results in the election this past month where Macri came within a few points of frontrunner Scioli and no one achieved anywhere close to the 45% required to avoid a run-off. With Massa's 20% of voters now likely to shift somewhat in Macri's favor, we have a real horse race and we have seen investors flooding back to the Argentina market with the Merval Index rallied a stunning 36% in October. We would anticipate further gains as we reach a conclusion of the election process in December, but there is likely to be some short-term consolidation over the coming weeks. Market participants still favor a Macri victory (more likely at this point, but still not the base case), but will settle for a Scioli government, as anything will be better than having Cristina in power.

Taking a moment to focus on China, looking at the very sharp drop in Q3, we were clearly caught off guard by the PBOC decision to allow a small "adjustment" in the RMB as they negotiate with the IMF for gaining inclusion in the SDR. The achievement of "Reserve Currency Status" for the Yuan is very important to the Chinese Leadership and they have been moving with purpose toward that goal. A gradual approach toward a more free-floating currency is what everyone in the world has been calling for, yet when it actually occurred in August 11th, everyone panicked and labeled the move a "Devaluation." Why is it when the Fed, ECB or BOJ weaken their currency by 20%, 30% or 40% it is labeled effective Central Bank management and when the PBOC moves the CNYUSD band a few percent it is deemed a crisis? Given the negative reaction, we were clearly "early" when we 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)." Taking a glass half full view, with the further correction in Q3, the CSI300 fell back to 10X forward EPS and looked like a buy again (now back to 12X with the 16.5% rally off the August bottom). We continue to believe that the media is incorrectly focused on the slowing of the Chinese GDP and the insistence that the numbers in China are "wrong" misses the point of the massive transition that is taking place in the economy. For the record, Strategas has done an analysis of 22 separate economic data series from China and used regression analysis to estimate the GDP and comes up with an average of 6.9%, which is exactly what the government recently reported. Importantly, 14 of the data series generated numbers above 7%, only two of the data series produced a number below 6% and the range was from 4.5% to 7.7%. The focus of analysis in China should shift to the Quality of GDP growth, not the Quantity of GDP growth as they undergo the same type of transition that the U.S. experienced over the past 40 years. We wrote last quarter that *"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)."* Clearly the volatility in the SHCOMP this year has been dramatic, but we expect that this volatility will continue to fade and the opportunity in Chinese equities, particularly in the sectors of e-Commerce, retail, staples, healthcare and energy will be compelling. Quoting Sir John Templeton again, *"Bull Markets grow on Skepticism"* and with rampant skepticism around the world on the prospect for China, we see plenty worry for the Great Wall of Money to climb in the China equity markets.

Fixed Income markets continued their volatile path in 2015 as the on again, off again, uncertainty about when the Fed will raise the Fed Funds rate created more dispersion in the bond markets. The Bond Bulls were back in control in Q3 as the Barclays Aggregate rose 1.2% and the Barclay's Long Treasury Index was up 5.1%, erasing the damage done by the Bond Bears in Q2 and pushing the indices back into the black for the year, up 1.1% and 0.2%, respectively. There continues to be a great deal of debate on what the Fed should/shouldn't do about interest rates and while we actually believe that there could be a positive "Signaling Effect" (help investors to be more confident) if the Fed were to actually normalize rates (get them back toward the Nominal GDP growth rate) we still agree with what we wrote last quarter that *"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."* Perhaps the equity rally that began when QEeen Janet decided not to raise rates in September confirms this view, as market participants seem to believe that having the Fed continue to promote low interest rates will somehow enable the global economy to avoid the Recession that appears to be developing. We wrote in the MCCM Ten Surprises in January that the Fed would confound the pundits this year and not raise rates. Our rationale was that economic growth would not rebound enough to support higher rates and all the recent data seems to confirm a pronounced slowing in growth in the U.S. (and globally as well). One of the other things we wrote about last quarter that bears repeating is a summary of Van Hoisington's view that *"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."* Van continues to believe that we have not seen the secular lows in long-term interest rates and we completely agree with that position as we expect the deflationary deleveraging that began nearly a decade ago to run for another five to seven years.

Across other fixed income markets, the investment

environment in Q3 was much more varied. We wrote last quarter that *"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."* Like in the U.S., the flight to safety as equity markets dipped did provide support for high quality bonds and the Barclay's Global Bond Index rose 2.0% for the quarter. The Index is still down CYTD, about (1.5%), due to the currency impact of the very strong dollar in Q1. In the credit markets, Q3 was much more like the challenging environment of Q2 (and seemingly eons away from the ebullience of Q1) as lower grade bonds were rocked by global growth fears and high yield and emerging markets debt spreads blew out to levels not seen since the Great Recession. Low quality assets really struggled as the Barclay's High Yield Index was down (4.9%) and the JPM EM Debt Index slipped (2.0%). One of the things we wrote about last quarter was that *"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,"* but that has indeed been the challenge when investing in credit markets over the past couple of years. Digging down a little deeper, the lowest quality assets, like the energy sector within high yield, really, really struggled and the HY Energy Index fell (16.1%) and is now down (12.4%) for the CYTD. We warned of the risks of this segment of the HY market last quarter and said, *"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."* The basic problem was that investors had rushed back into the energy debt space in Q1 with the "Buy the Dip" mentality, but didn't stop to assess whether the fundamentals of the industry had actually improved. There was, as you might expect, a reflexive response to the flood of money into the segment and prices did lurch higher for a while (and investors celebrated), but oil prices faded due to the reality of oil supply continuing to exceed demand and HY prices began to reverse. The downward spiral accelerated as global growth numbers began to roll over and a couple of energy companies were forced to declare bankruptcy. Restating the case for the opportunity in this area from the January letter here, *"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."* We were just in London again last week visiting with that oil trader and he continues to believe that we will see lower prices in the oil patch for much longer than the consensus believes. We have just entered the new evaluation period for the LOCs for the energy companies and we expect to see some painful decisions made by the banks, which will lead to some significant distress. All the money that went chasing energy debt in Q1 is now nursing some meaningful losses and we actually think these markets will get worse before they get better. Eventually some of this paper may find its way back to the market and we are beginning to explore ways to have fresh capital available to buy great assets at those great fire sale prices when they finally occur in the coming quarters.

Over the past year there has been some significant divergence in yield assets, some have done well, some have done poorly, which has been a little surprising since one might assume that assets which investors purchased primarily for yield would move together

(would rise in falling rate environment and fall in rising rate environment). The one thing missing from that analysis is the source of the yield can be impacted by different things and one asset could break rank if the fundamentals of the underlying business changed more than the change in the interest rate environment. Such was the case in Q3. As investors began to believe the Fed jawboning about the imminent rise in interest rates they actually came running back to REITs in the quarter and the S&P REIT Index was one of the very few assets to post a positive return, up 2% for the period. REITs are still down (4.2%) for the year as the vicious selling in the first half of the year when investors were disappointed that the Fed didn't raise rates overwhelmed the positive returns in Q3. We wrote last quarter that, *"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."* Those that avoid the pain of discipline will have to deal with the pain of regret and we have seen over and over in the past few quarters that being sure to sell into excessive strength and buy into excessive weakness has been the superior investment strategy. We also noted last quarter that, *"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 Q3 pain in the MLP space made the Q2 fall of (6.1%) seem almost trivial as the Alerian MLP Index fell an astonishing (22.1%) during the quarter. The breadth and depth of the decline in MLPs has been breathtaking, exacerbated by the rapid unwinding of leveraged mutual funds, which were forced to sell and pay down debt as margin calls came fast and furious during September. These fund structures were created in an attempt to manage the unattractive tax consequences of MLPs for individual investors (essentially double taxation), so the theory was that by levering up the portfolios, the extra returns could effectively pay the tax and the net return to investors would be higher. As is always the case with leveraged investments the theory works great when markets are calm and rising, and can be disastrous when markets are volatile and falling. We wrote last quarter that, *"with these types of corrections, we once again see that it is okay to be a couple hours early, but not a minute late"* and it is likely that in capitalizing on these types of dislocations it will also pay to be a little early and begin to buy before the prices hit absolute bottom. The challenge in the MLP space is that there are some great assets being thrown out in the oily bathwater, but also some assets that should never have been put into the MLP structure (more cyclical businesses) that will likely fall much further.

Jumping over to the Commodity markets, Q3 was, frighteningly, even more confusing than Q2. We wrote last quarter how *"some areas showed some resilience and others continued their steady march downward with King Dollar on holiday as some of the financial downward pressure on prices was briefly eliminated."* Much of the discussion in the commodities markets focuses on the impact of the strong Dollar and thus the consensus belief that the Fed would raise rates in September should have led to a much stronger Dollar and lower commodity prices. The confusing part of Q3 was that commodities did indeed get crushed, but the Dollar barely budged and DXY was only up 1%. A fractional move in the Dollar should not have led to double digit losses in commodities, so the explanation quickly shifted to fears of a hard landing in China (despite no real evidence of such), an uneven recovery in developed markets and rapid deterioration in growth in developing markets. Oil made the most dramatic move in the quarter falling (24.1%), reversing the extraordinary 25% recovery from Q2 and plunging CYTD returns solidly back into negative territory at (11.3%). The damage from the 2014 peak of $107.26 is extreme; with prices back down below $45, the TTM return is a very unattractive (42.0%. Looking at oil

this year it makes sense to revisit again our Q4 2014 commentary where we wrote *"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."* We highlighted in our 10 Surprises that there was not one Wall Street analyst that had a year-end price target for WTI Crude Oil below $60 and that most of the public E&P companies were still discounting $70 oil prices. We wrote last quarter that, *"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 have been very consistent in our view on the developments in the oil patch and have positioned portfolios to reflect our negative near-term views by lightening up on energy related investments and looking for second order opportunities to invest where companies (or countries) benefit from lower oil prices. We continue to see opportunities in Airlines, Cruise Lines and Transportation companies where fuel is a large component of costs and we continue to see opportunities in countries like China and India which are net importers of oil. Last quarter we reiterated our view from the 10 Surprises saying *"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, as 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. That is our story and we are sticking to it, but are still reserving our right to change our minds if the facts change, like if Saudi Arabia decides to cut production in November (unlikely, but would be a game changer) or if the Syrian conflict escalates (possible) or some other supply disruption takes place. We will see U.S. production begin to decline marginally, so there is some chance that a positive demand surprise in 2016 could trigger some firming in oil prices, but we will likely have a couple opportunities to write about those developments if, and when, they occur over the coming quarters.

Contrary to popular belief, there are some other commodities besides oil and they were all taken to the woodshed once again in Q3 (reminiscent of the famous pirate line that the beatings will continue until morale improves…). Looking at Natural Gas, we discussed last quarter the potential for a tug-o-war between developing weather patterns and continued supply growth, saying, *"The threat of a monster El Nino event that could cause above average temperatures has seemingly put a little floor under Nat Gas. That said, 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."* While there was a short period of consolidation, supply growth completely overwhelmed demand growth and prices began a free fall in September, finishing down (10.8%) for the quarter to bring CYTD losses to (20.5%) and peak to trough losses since 2013 to a staggering (47%). So much for range bound. In October, prices completely collapsed as a warmer Fall led to lower Natural Gas usage and we are in danger of reaching the dreaded $1 handle again. During the summer, we did an Around the World Webinar on *The Four Horsemen of the #Growthpocalypse,* which highlighted the four indicators of a pending U.S. Recession; Copper prices, 10-year Treasury rates, the KOSPI Index (Korean equities) and Oil prices. Copper has historically been one of the best indicators of the direction of the economy and the huge decline since 2011 (from $464 to $236 today) and another recent bout of downside volatility as the metal shed another (10.5%) in Q3, the growth story is looking challenging. We wrote last quarter, and we will reiterate here, that *"so far, with*

no signs of a sustained rally and with new warnings about China's flagging growth, Dr. Copper may be in the Infirmary for a while longer." Precious metals have been lackluster all year and Q3 was no exception as Gold fell (4.9%), Silver dropped (7.7%), Platinum plunged (15.9%) and Palladium fell (3.4%). These losses brought CYTD returns to (0.6%), 2.1%, (16%) and (12.7%), respectively. Finally, Agricultural commodities have been some of the most volatile as Wheat, Soybeans and Corn fell (13.2%), (5.4%) and (7.2%), respectively, in Q1; did a complete reversal, soaring 20.3%, 6.6% and 12.2% in Q2, respectively; only to collapse again in Q3, plunging (19.9%), (10.7%) and (10.5%), respectively. At these levels of volatility, the grains might be considered "untradeable" and we have spent very little time in this area as the wild gyrations related to changing weather forecasts and production surprises have not lent themselves to solid fundamental analysis. Perhaps these markets will revert back to a more consistent trend following pattern, but until then, we will leave them to those with higher levels of short-term trading acumen. One big thing to watch in the commodity space is something we mentioned last quarter that *"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 the fierce headwind for commodities were to subside."* Given that QEeen Janet showed her true colors and didn't raise rates in September (and we think she is unlikely to raise rates for a while), there could be some continued Dollar strength so the commodity headwind would not subside quite yet, but all cycles turn and given the decimation across the commodity complex, some of the moves off the eventual bottom will create tremendous investment opportunities.

It has been a tough few years for hedge funds and we wrote last quarter that they were suffering from *"a long string of underperformance relative to long-only equities as they battled the headwinds of broken deals, zero interest rates and relentless short squeezes."* Hedge Funds did outperform quite nicely in Q3, as one might expect given the dramatic sell off in equities, but the relative performance was diminished in the equity segments affected by the infamous Hillary Clinton tweet that set off a firestorm in the healthcare sector. It seems quite extraordinary that 140 characters could trigger a sell off resulting in the destruction of hundreds of billions of dollars of equity market capitalization, particularly when the proposals referenced are not new (same as she proposed in 1994 and the current administration campaigned on in 2008) and that the majority of the proposals require an act of Congress (which is highly unlikely since the Republican controlled Congress has to answer to a very strong healthcare lobby), but there was huge damage done in the specialty pharma sector and a number of managers posted really terrible results in the period. The headlines trumpeted the failure of hedge funds, however, it wasn't the hedge"D" funds that struggled, but rather the long-only, activist funds (arguably shouldn't be called hedge funds despite the fact that they charge incentive fees) that suffered the most from the healthcare turmoil. The HFRX Global Hedge Index was down (4.7%) for the quarter, which might appear unattractive on an absolute basis, but when compared to the loss of (9.5%) in the MSCI ACWI Index, it looks fairly good. If we look at the CYTD, the Global Hedge loss of (3.1%) is right in line with a goal of limiting losses to 40% to 50% of the long -only benchmark, as ACWI is down (7.0%). In the U.S. the results in Q3 were not quite as strong as globally as there were a lot of managers who were impacted by the healthcare debacle and the HFRX Equity Hedge Index was down (5.4%), not much better than the S&P 500 decline of (6.4%), but was significantly better than the R2000 drop of (11.9%). That said, looking at the CYTD numbers, the long/short managers have dampened volatility somewhat, falling only (3.1%) versus the S&P down (5.3%) and the R2000 down (7.7%). We still feel strongly about what we wrote last quarter, that *"we will continue to make the case for utilizing hedged strategies rather*

than long-only strategies in the equity markets as we have been for that past year. While we were slightly early, we expect to see the relative performance advantage of hedge funds continue to expand as 2015 winds to a close and the tougher period of 2016 to 2017 begins (in our 2000 to 2002 déjà vu scenario)."

As mentioned above, the real pain in Q3 was felt by the Activist funds as some of the largest brand name funds are down (15%) to (20%) for 2015 (most of those losses coming in Q3) and the HFRX Event Driven Index was down (7.7%) for the quarter and is down right in line with equities CYTD, off (6.4%). We have never had much exposure in the Activist space and while there are a handful of groups (like ValueAct) that have produced strong results over the long-term, we have not found the level of Alpha we like to see to warrant paying hedge fund fee structures. The inherent Beta of these strategies was quite apparent in Q3 and some of the luster seems to have worn off after being the "hot" strategy in 2014. On the other side of the balance sheet, the HFRX Distressed Index had a very challenging quarter, losing (5.6%) as credit spreads widened to levels not seen in many years and there were rumblings of rising defaults on the horizon. One area that was hit particularly hard was the energy space as the collapse in oil prices in Q3 put renewed pressure on overleveraged E&P companies. We warned earlier this year that all the money being raised to chase after the energy debt markets might be premature given our view on oil prices was that they would be #Lower4Longer. After rallying hard in Q2, energy related debt crashed hard in Q3 and there were a small number of bankruptcies (there will be more) which led to a general repricing of bonds in the sector. The October LOC reset period has now come and gone and we would expect that there will be increasing stress in the oil patch in the coming quarters and that the distressed debt sector will provide some compelling investment opportunities, but not until later in 2016 and 2017.

The star performers in the hedge fund space in Q3 were the groups that had been written off as irrelevant over the past few years as consensus became, "who needs macro and absolute return in a QE led bull market?" The key to long-term wealth creation is the avoidance of losses (as we mentioned above, if you take care of the losses, the gains take care of themselves) and Q3 was all about preservation of capital. The HFRX Absolute Return Index managed a 0.6% gain for the quarter, which brought CYTD returns to a positive 2.6%. While the gains are nothing to particularly crow about, Absolute Return strategies (Merger Arb, Market Neutral) have been fighting against the stiff headwind of ZIRP, so producing real Alpha during a very challenging environment is notable. If we look back at the 2000 2.0 scenario, equity investors lost (40%) over that three year period and Absolute Return investors made nearly 20%, which means you end up with twice as much money at the end of the period ($120 vs. $60). In Macro, again the headlines were far worse than the results as the media frenzy around the decision by Fortress to shutter their Macro fund drowned out the fact that the HFRX Macro/CTA Index was basically flat during Q3, down (0.2%) and is only down (1.6%) for the year. In an environment where global equities are down (7.0%) for the year, these are attractive returns and the low correlation of the return stream to traditional assets is another attractive feature of these strategies that does not receive enough attention. These funds tend to zig when the markets zag and can provide very strong protection in difficult markets, as we saw in 2008. We wrote last quarter that *"we continue to see very significant benefit 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"* and while the Barclay's Aggregate Index bested the Absolute Return strategies in Q3, the CYTD numbers favor the hedge funds and we reiterate the call for swapping from Bonds to Absolute Return.

The third quarter of 2015 accelerated the trend of the first two quarters, as traditional markets produced quite disappointing returns thanks to rising volatility related to uncertainty about global GDP growth, declining corporate profits and lack of decisive Central Bank action. Global equities markets were very inhospitable in Q3 and the dramatic losses erased most of the accumulated gains over the past year. In fact, there are only a handful of markets that provided positive returns to investors over the trailing twelve months. In the developed markets only Denmark, up 6.7%, Ireland, up 10.9%, and Israel, up 2.6%, managed to produce gains. In Emerging Markets, China A-Shares were the star performers rising a stunning 28.7% and Hungary also managed a small gain, up 6.7%. In Frontier Markets, Estonia eked out a 0.8% gain, Botswana rose 3.9% and Jamaica surged 38.6%, but all three of these markets are tiny, illiquid and not very accessible to most investors. We asked an important question in the Q1 letter, *"how many investors had more Japan and China equity exposure than U.S. equity exposure over the past year?* We continue to believe that the answer is not many, despite the fact that the continued reforms in China point to a robust market opportunity that is likely to produce far superior returns for investors over the coming decade than U.S. equities. It is rather extraordinary that as you listened to the media frenzy about the hard landing that is imminent in China, how the equity market bubble popped this summer and how the Yuan is about to collapse, one might not actually look at the data over the past year and see Chinese equities up nearly 30% while U.S. equities are essentially flat. We wrote last quarter that *"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"* and the idea that investors should have more Chinese equities than U.S. equities in their portfolio over the coming decade would cause significant discomfort and, therefore, has a better than average chance of being right. Michael Steinhart says you make the biggest returns when you take a position based on a Variant Perception that turns out to be right. Those of us that use Twitter, will remain focused implementing the #VariantPerception investment model and will endeavor to #LiveOutsideTheComfortZone where all the best investment opportunities exist.

Our investment activities continue to benefit from the convergence between the public and private markets. "*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 Carolina) and we have a great navigation plan based on the Endowment Model that is designed 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 should stand up to whatever the Gods throw our way.

Market Outlook

We opened last quarter's Market Outlook with an observation that the current environment was beginning to look a lot like the Tech Bubble saying *"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."* The last part about the Yellen Put came true at the end of the

quarter when QEeen Janet surprised everyone (except us, in fact I was on CNBC on the September 16th saying no increase) and did nothing despite the consensus that lift-off for rate increases would occur on September 17th. Interestingly, U.S. stocks were only down a couple percent, having rallied back from their nadir of down (8%) on August 24th, but international and EM stocks were down significantly more and the Fed decided it needed to add Global Equity Market Stability to its mandate. The immediate reaction of market participants was "uh-oh, things must be really bad" and the S&P 500 sold off (5%) in a matter of days and was poised to make new lows on September 28th, which looked likely to trigger some serious unwinding of leveraged accounts. Things were looking a little precarious. Then in a very déjà vu moment harkening back to 2011 (it has actually felt like 2011 all year with Greek Crisis 2.0), Mario "Whatever it Takes" Draghi threw the Bulls a lifeline and said that the ECB would increase their QE program within the next six months. In usual Draghi style, he actually never committed to anything specific, other than saying they stood ready to extend the program beyond 2016, but that was enough to get a good short-squeeze rally started. Investors then began to decide that the Fed not raising rates was actually a good thing (meant multiples could expand a little more since sales and EPS keep falling) and equity markets around the world went up nearly every day in October, pushing equities to their best month in since, you guessed it, October 2011. The similarities with 2011 are amazing, in both years the market peaked in May, had an initial trough in August and then had the final bottom 5 days apart, September 28th this year and October 3rd in 2011. In 2011, the S&P 500 rallied 14.5% from the October bottom and so far in 2015 the Index has rallied 11.5% off the bottom.

We have been leaning toward the cautious side since late last year when we wrote *Highway to the Danger Zone* as we saw some of the brightest investors in the world getting increasingly more defensive. George Soros, Julian Robertson, Seth Klarman, John Burbank, Russell Clark and a number of others were moving to more hedged positions and a few of them were even moving to net short positions. As we think about our big picture portfolio postures, not much has changed in the past three months, but there have been a few minor modifications. We still favor Active Management over Passive/Index Strategies overall as we believe that the next few years will be all about Alpha and not about Beta (the term Smart Beta is likely to look like an oxymoron). We increasingly favor being hedged over being long only in the U.S. and given the huge dispersion in relative valuation across the sectors we think the environment is extraordinary for long/short strategies. A slight change is that we are now leaning back toward being hedged in Japan and Europe as after the huge Beta run in the past month we think it is time to favor long/short again. We want to favor Emerging Markets (selectively) over Developed Markets, but the volatility in EM currencies is making us nervous short-term (over the long-term, next five years, EM should beat DM handily). The biggest opportunity we see to create excess returns still remains in favoring Private Investments over Public Investments with an emphasis on Small Buyouts, Asian Growth Capital, International Venture Capital (India and China) and Energy Reserve Acquisition. We have written for a few quarters, and will reiterate here *"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."* A very important point here is that just because we have a less than sanguine view of the U.S. equity market in the next few years does not mean that we are overly Bearish or that we don't see opportunities in other equity markets (or other markets more broadly). On the contrary, just like in 2000, we see fantastic opportunities to make money all around the world we just don't see robust opportunities in the traditional 60/40 U.S. Stock/Bond portfolios. Interestingly, Vanguard came out recently and said that they expect a traditional portfolio of stocks and bonds in the U.S. will generate 3.5% returns over the next decade. There

is a technical term for that return. It stinks. There are lots of ways to do better and we will explore them here.

Over the three-year period from 2000 to 2002 the S&P 500 lost (38%) and then fought back to be down "only" (1.1%) compounded over the next decade. Similarly, EAFE managed only a 1% compound annual return. By way of contrast, Emerging Markets equities soared 10.5% per year (which for perspective turns $1.00 into $2.71, versus $0.90 for the S&P and $1.10 for EAFE). Hedge Funds produced outstanding returns during the Tech Wreck, compounding at 10% on average over the three years (with many of the Tiger Cubs compounding close to 20%). We wrote last quarter that, *"long-term returns are primarily determined by the valuation you pay when you enter. 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."* There is a common theme in making money in each of those opportunities, having the discipline to break from the consensus and do the opposite of the rest of market participants, to sell what everyone else is buying or to buy what everyone else in selling. Ben Graham said it best (often attributed to Buffett, but Ben said it first), *"Be fearful when others are greedy and greedy when others are fearful".* What makes this discipline particularly challenging is the feedback you get from the market consistently tells you that you are making a mistake. As you begin to sell, prices continue to rise (for a while) and as you begin to buy, prices continue to fall (for a while). George Soros has a solution to the problem, he says that "investors begin from the premise that the current price is correct, we begin with the premise that the current price is always wrong" and John Burbank says it more succinctly, "Price is a Liar". We believe that we have entered 2000 2.0. We know from history that investors could not see that the crazy prices for Internet companies in 2000 could ever fall (neither did Business Week which published a cover story to that effect in April of 2000), but we also know from history that the next three years was particularly ugly for investors in NASDAQ as the Index plunged (78.4%) from peak to trough. We wrote last quarter that, *"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."* Some of the greatest value managers ever were put out to pasture in 2000 (Robertson, Dye, Brinson) and today a number of hall of fame value investors like Mason Hawkins are under attack as Value strategies have been trounced (Longleaf Partners is down (14%) CYTD). Usually when the cacophony is the loudest, the turn is imminent.

In Julian Robertson's final letter to investors when he closed the Tiger Fund in 2000, he stated that he was confident that the discipline of buying good companies at cheap prices and selling short bad companies at high prices would endure, but that '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". He went on to say that in predicting when the environment would return to normal that he had no special ability. We wrote last quarter, and reiterate here, that, *"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."* One of the challenges of investing in the current environment is that global financial markets are orders of magnitude more complex today that fifteen years ago and the speed at which markets move has made it increasingly more difficult to manage risk in the traditional model

of stepping to the sidelines in anticipation of an event. Take the most recent correction in healthcare as an example. One tweet, less than 140 characters of text, from a presidential candidate (not a person with any position of power) caused hundreds of billions of dollars of market capitalization to vaporize in a matter of days. If you weren't hedged before the event, there was no way to get hedged during the decline. While there is clearly no way to predict this type of event, there were elevated levels of valuation in the healthcare sector that should have prompted disciplined investors to increase their hedged profile over the course of the year and that positioning could have mitigated some of the downside during the eventual correction. We discussed this issue last time in saying *"the essential problem that we highlighted last quarter is that when it comes to bubbles and crises, you can be a few hours early, but you can't be one minute late."* We would argue that a better solution is to follow A.W. Jones and always be hedged and utilize the superior technology that is long/short to gain exposure to the equity markets. The beauty of substituting long/short for long-only is that over the long-term you don't give up return, you only give up volatility and risk and, most importantly, you remove the emotional roller coaster that causes the average investor to sell at the bottom, crystalize the loss, and restrict the power of compounding over time.

The first time we wrote about A.W. Jones was a couple of quarters ago when we discussed how Julian Robertson had been introduced to the hedge fund model by Jones' son-in-law (who Julian worked with at Kidder Peabody) and that he was mentored in the long/short process by Jones himself. I want to repeat one of the quotes from that letter here as it summarizes so elegantly the simplicity of the Hedged Fund model. *"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."*** *The problem of course is that is like a professional golfer saying you just drive the ball down the fairway, hit an iron to the green and two putt, it is a simple game."* So clearly this is easier said than done and another challenge is that the game has changed over the past few decades that make it even more difficult to execute effectively. In the early days, there was actually something called a "short interest rebate" that an investor received from the prime broker when they shorted a stock and this was a small source of return that was received just for playing the game (like getting a stroke on a hole when you play a better golfer). Today, an investor has to pay to borrow stocks to short and that cost can be quite high when a lot of people want to short the same company. Again there has been a big change here in that in the early days there weren't that many funds shorting, so there was less demand for borrowed stocks. Today, there are thousands of funds all trying to borrow similar stocks and the cost of shorting has become quite a meaningful hurdle to overcome. If you have good security selection Alpha, it is still possible to generate strong returns, but not everyone has consistent Alpha. The other problem is that there will be times when the worst companies actually outperform the best companies (usually when there is excess Central Bank liquidity like in 1995-2000 and again in 2009-2014). During these periods, hedge fund investing looks like a really bad idea and toward the end of the period, it seems like a downright dreadful idea. That is precisely when it is the most important time to increase exposure to the strategy. We will argue that long/short is a better way to manage equity all the time, but at a minimum, investors need to increase hedged strategy exposure when valuations are high (like they are today). Finally, we talked about one of the unique ways Julian has enhanced his investment strategy over time, saying *"the thing we admire most about his business model today is 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."* A.W. Jones had a variation of this idea in that he would outsource capital to individuals who he thought had great

investment ideas and then super-size their ideas in the partnerships, proving once again that most great ideas have been around a long time.

So let's take our usual Around the World Tour and see where the most compelling investment opportunities are today. Starting in the U.S., we should set the stage by restating our view from the beginning of the 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."* Things were looking pretty good on this projection through the last couple days of Q3 as stocks had slipped into a fairly sizable hole, down around (8%), and there was an increasing sense that things could start to get ugly in a hurry. Earnings growth has turned down (which has historically been a stiff headwind for stocks) and the confusion around the Fed decision not to raise the Fed Funds rate in September was putting pressure on stocks. Four short weeks later, everything is awesome again and the S&P 500 is back in the black CYTD and the pundits are starting to talk about the Santa Claus rally as the Red Cups have arrived at Starbucks. We don't share the ebullience for the general market as forward S&P EPS peaked in the summer of 2014 and with the Q3 decline following the Q2 decline we have now had two consecutive negative quarters of earnings for the first time since 2009. Another issue is that if the Dollar were to return to strengthening, which would put further pressure on commodity prices, especially oil, Q4 EPS will likely be even weaker and with forward P/E ratios already stretched, at 16.6, we find it tough to make a bullish case for the broad market. The conundrum is that with the Fed making noises that they want to go ahead and raise interest rates at the December meeting, the Dollar is likely to reaccelerate upwards, which means further declines in prices (Deflation) and earnings. We wrote last quarter that *"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."* Today, the $64 trillion question is whether Ms. Yellen remains QEeen Janet in December or turns into Lucy Van Pelt and yanks the football away right as Charlie Brown (investors) takes a big kick and ends up flat on his (their) back.

With all that said, there are still segments in the U.S. market where we see opportunities for strong managers to generate Alpha and we will continue to overweight those industries. We wrote last quarter that *"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."* The now infamous Hilary Clinton tweet about wanting to attack drug companies for price gouging was one of the more egregious examples of pandering for votes we have seen for a long time. The proposals presented the next day were a retread of the proposals she made all the way back in 1994 and not much changed from the proposals made by the current administration in 2008, so there was little new information, but the reaction in the markets was swift and brutal as XLV (healthcare) fell (11%) and IBB (biotech) fell (20%) in ten days. The damage was much worse in the specialty pharma area as high profile company Valeant (VRX), made famous last year by Bill Ackman, fell (30%) and one of our favorite healthcare managers' top holding Horizon Pharma (HZNP) fell an astonishing (45%) despite giving advance guidance that they would have a huge Q3 EPS report. Over the past month most of the healthcare space has recovered sharply along with the indices and XLV rose in line with the S&P 500, up 11%, and IBB surged 14%. Unfortunately, everyone piled on the Valeant story and accusations of accounting irregularities and aggressive business practices have put further pressure on VRX, which

has shed another (50%) to be down (65%) from the peak. HZNP on the other hand, followed through with their blowout quarterly EPS report and rallied 22% in one day and is now up 17% from the trough at the end of Q3. Horizon is a great long-term story, but it will likely remain volatile during the next year, as the election debate will clearly include beating on drug companies (older voters tend to buy a lot of prescription drugs) to lower prices.

Another sector where we continue to see opportunity is technology as the continued innovation in areas like mobile communications, big data, the internet of things, cloud computing and security are creating lots of winners and losers. The rate of creative destruction and destructive creation is accelerating and that is leading to an increasing number of investment opportunities on both the long and short side. We do have one concern which is that the market is getting awfully narrow (in technology and consumer in particular) and only a small number of stocks are rising quickly, led by the FANG group of FB, AMZN, NFLX and GOOGL (perhaps we should be concerned that a nickname like FANG implies something that could bite…) which continue to out-execute most other tech companies. One perspective that tempers our concern about the rapid price increase in these names somewhat was a quote from Julian that we included last quarter, *"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."* Interestingly, since Julian made that comment, FB and GOOGL are up 40% while AAPL has not been quite as robust, only up 10% (still double the S&P 500 increase of 5%). Even more interesting, however, is that as you might expect after that run of performance is FB does now have a P/E ratio that is looking fairly 2000-esque (107), GOOGL is a little expensive (32) and only AAPL remains cheap with an amazingly low P/E of 13. There are a tremendous number of technology companies today for investors to choose from and the dispersion in valuations is quite astonishing, so we would lean toward playing this sector with specialty long/short managers. We wrote last time that *"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)."* That trend has continued in Q3 and we continue to see robust deal flow where we can deploy meaningful capital into late stage investments in great growth companies at attractive prices. While no one would characterize the pricing in these companies as cheap, we don't agree with the media fear mongering that all of the private companies in the "Unicorn Market" are wildly overvalued. A couple of examples in our portfolios are Koudai and Lyft which have both experienced material uplifts in valuation this year because growth rates have continued to accelerate and execution has exceeded plan across the board. While there have been some high profile disappointments like Evernote where investors will lose money, we continue to see solid discipline in the venture and growth equity firms to promote the winners and shut down the losers.

The best performing sector in the U.S. this year has been Consumer Discretionary, which is up a very strong 14%. However, as we mentioned in the Not So Nifty Fifty list above, there has been a worrisome trend in the equity markets in 2015 and that is the extreme narrowing of the markets where only a small handful of companies are truly outperforming and the average stock performance ranges from mediocre to poor. We talked about FANG above and the two consumer names, AMZN and NFLX are part of a Tremendous Trio along with EXPE (ANE) that have driven more than all of the gains in the consumer sector. With EXPE up 55%, AMZN up 115% and NFLX up 130% CYTD, if you remove them from the index, the consumer sector is actually down for the year. Narrowing markets have historically been

harbingers of meaningful declines as when the bulk of companies in a sector or market struggle, investors eventually get the message and sell. The other disconcerting thing about the broad weakness in the consumer sector is that with the collapse in oil prices leading to a collapse in gas prices there was supposed to be a spending boost from the windfall savings, yet the actual retail sales figures have shown the opposite, a declining trend that looks more like what we would expect during a Recession. Perhaps being too cute by half, the ANE trio is only one letter away from PANE (which may be what is in store ahead) as Pandora gives us an example of what can happen in a fragile market. P was zooming along this year as rapid adoption of the music streaming service into cars was occurring ahead of plan when the integration hit the proverbial bump in the road (pun intended) and went from being up 25% in the first week of October to down (30%) today. The challenge with markets that are priced for perfection is they tend to punish investors when perfection is not achieved (actually funny how it never is…).

Looking across the pond to Europe, the roller coaster ride has been quite extreme in 2015 and we can look at Germany as an example. With the discussion about the ECB QE program turning from theory to reality in January, the DAX Index shot upwards like a rocket in Q1, rising 25% (in local currency terms, the USD return was a much more muted 11% because of the collapse of the Euro). The next six months were significantly less fun for German investors as all of those gains (and then some) were erased and the DAX stood at (3%) on the final day of Q3. But Super Mario tapped the keg for Oktoberfest with more "whatever it takes" jawboning and the Bavarian equities surged 16% off the bottom to be up 12% for the CYTD. Again these returns are in Euros and a U.S. investor (who didn't hedge) is flat for the year (after being down as much as (10%) in Dollars) at the end of Q3. Interestingly, the economic and profits performance in Germany has been less than stellar this year, but as the largest (and most liquid) market, capital flows seeking to front-run the ECB have tended to favor EWG and EWQ (France). Even the massive scandal surrounding Volkswagen has not been enough to derail the German liquidity express. By comparison, we wrote last quarter that it was one of the most unlikely markets, Ireland, that has been the standout performer, both in terms of economic performance and equity market performance. We said that, *"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 Ireland has given some of those gains back and is now "only" up 14% for the CYTD (in USD, in Euros a much more robust 26%) it remains one of the best performing markets in the world in 2015. Italy has held most of its gains (in Euro terms), yet Spain has continued to struggle, perhaps because of lingering fears about the far left party gaining momentum in the elections. Contrary to our belief that things would turn after the elections in Q1, Greece has struggled all year and while it has been one of the top performing equity markets in the world since the bottom on August 24th, there is still some unfinished business in terms of getting the banks recapitalized that is putting continuing stress on the Athens market. We see lots of great Greek businesses selling at attractive prices and it could be one of the big surprise markets in the coming year.

We wrote last quarter that *"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."* The managers were convinced that top line growth would hold up and that profit growth would follow, primarily resulting from a weaker Euro (as we have mentioned before, Europe has taken Mercantilism to an art form), but also from controlling costs through the integration of new technologies (positive for tech company EPS). We were back in London a few weeks ago and sat down with our favorite "Odd Couple" (a 1970's TV show about two men with extremely different personalities

who were roommates), the two portfolio managers for one of our favorite firms (one runs the Europe Fund and one runs the Global Fund) and they could not be more different in how they have positioned their overall portfolios, but they share the same overall opinion on Europe. The one running the Europe Fund (we will call him Oscar) is 140% net long today with a monster (60%) overweight in European financials, while the one running the Global Fund (we will call him Felix) is 60% net short, yet he is also overweight European financials. They are not quite as excited about European Cyclicals like our other favorite London manager, but they would agree with his contention that the worst is over in Europe and it would be a bad idea to Fight the ECB at the present time and be too short European equities. So how does Felix actually get to a net short position? He is short huge amounts of U.S. equity (across a half dozen different industries) and is also short EM FX and he takes the exact opposite view that we have on Japan, he is short Japanese equities and long the Yen (directly opposed to MCCM Surprise #9). Oscar doesn't see these risks as being significant, however, he is less exposed to the big German and Swiss banks and more exposed to Italian, Spanish and a couple of French institutions. Depending on where we are in the commodity Super Cycle these moves could generate significant Alpha in the near term if we truly are closing in on a bottom in the cycle.

We have been trying to get excited about Europe since last year when the economy seems to have bottomed and Draghi finally solved the QE structure problem (hence the continued trips to Europe/London to talk to managers), but we haven't been able to find a way to capture any consistent Alpha. One of the things holding back on Europe has been nagging concerns about bank exposure to commodities and emerging markets. As the commodity unwind accelerated in Q3, rumors began to fly about massive potential bank losses related to Glencore, culminating in a story that made the claim that if Glencore went down, Credit Suisse would go down right behind it. The media never likes to let the facts get in the way of a good story (actually we always endeavor to pay attention to the facts rather than the story), but looking at the data things don't necessarily add up to the extreme view. Both Glencore (UK:GLEN) and Credit Suisse (CH:CSGN) were moving in line with the markets (flat) from January through May and then Glencore began a horrific slide, falling (80%) through the end of September. Curiously, CS actually rallied during the summer, rising 20% from May to July before finally rolling over in August and giving back all the gains to finish back flat to end Q3. Even more curious, Glencore rallied almost 100% off the bottom during the first week of October and both stocks have been essentially flat for the past month. The numbers being bandied about concerning loan losses to the banks from commodity businesses are of similar magnitude to the potential losses being attributed to the U.S. banks on their loans to the shale oil industry (in the hundreds of billions) and we have been concerned that this unwind (if it were to actually occur) could be the #BlackSwan that triggers a big correction (like Telecom in 2001 and sub-prime in 2008). It is tough to argue with Oscar and Felix as they live and breathe Europe every day, so we will continue to slowly build our Europe exposure with an eye toward buying some extra of what is "on sale" in the financial and commodity spaces should the recent momentum continue.

Japan has been one of our favorite markets for the past three years and the returns since Abe-san was elected in 2012 have been quite strong. The Abenomics plan was elegant in its simplicity; weaken the Yen to stimulate exports and profits, expand fiscal spending to spark growth and kindle inflation and make regulatory changes to encourage innovation and new business formation. Weakening the Yen has been relatively easy, as the BOJ (and Governor Kuroda-san in particular) has done a good job (up until this past month when they disappointed markets with no stimulus expansion) executing the plan and moving the USDJPY from the high 70's to 123 today. Fiscal stimulus has been robust as years of under spending by the government have begun to reverse

and while there is a lag between the spending and the growth, meaningful progress has been made. The third leg has been more elusive as even with a majority in both houses, Abe-san has not been as successful as expected on the reform agenda. However, even without the policy trifecta, the primary driver of equity returns, corporate profits, have surged and Japan Inc. has been setting records every quarter (in fact, even with the Nikkei up big, the P/E ratio has fallen since E has grown faster than P). We wrote last quarter that *"in speaking with our favorite Japan manager in London last week, they remain very bullish, fully invested and making a big bet on the financials, in particular the Mega-Banks (SMFG, MTU, and MFG). They see the potential for unwinding of their cross shareholdings as a huge deal and these stocks could rise 50%+ in the coming year."* Unfortunately, U.S. investors did not share their enthusiasm and selling by foreign institutions was huge in Q3 and returns for Japanese equities (banks in particular) were poor. In talking to them we had asked if they were getting lots of interest from potential investors given their strong returns over the past couple of year and we were surprised when they said they were not and that foot traffic to their offices was very light. We wrote about our feeling about this kind of anecdotal evidence, saying *"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."* Having just been back in London a few weeks ago and having some of the team travel to Tokyo for the annual Goldman conference, we can confirm that there continues to be little to no interest in Japan from global investors, which we see as a positive sign for prospective returns.

Emerging Markets was an unmitigated disaster area in Q3 as anything that could possibly go wrong actually did go wrong. Fears of global growth slowing down, check, concerns about China hard landing, check, PBOC making surprise move to weaken the RMB, check, EM currencies collapsing on fears of rising U.S. rates, check, prices collapsing as investors flee the space, check, check. We entered 2015 with some cautious optimism and things were looking good through April, but had begun to turn down as we penned the letter last quarter and said *"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."* When we have talked about EM in the past couple of years we have focused on differentiating between Service economies and Commodity economies as the former benefit from falling commodity prices and the latter are hit hard by falling commodity prices. We discussed this perspective in an early Summer ATWWY Webinar and wrote in July that *"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."* So while we had moved from cautiously optimistic to cautious as we entered Q3, we clearly should have been more aggressive in our cautious positioning during the quarter. That said, as has been the pattern of equity markets in the QE regime, the harder something falls, the higher it bounces when liquidity returns and EM followed this pattern to an extreme in October. The question we have to answer today, looking forward, is whether this most recent strength was merely short covering or whether there has been a turn in the markets to favor Cyclicals and Emerging Markets. 13D Research has put out some interesting thoughts on the construct that Emerging Markets have had failed rallies in both 2013 and 2014 trying to break out of the down trend that started in 2011 and that the EM Index was approaching the resistance line again for the third time. If the third time is the charm and the Index can break through the resistance, then a new uptrend is possible and it would be time to get more aggressive in increasing EM exposure. We will be watching the 40-level in EEM very closely.

One of markets that we thought would be full of

surprises in 2015 was Bonds and the fixed income markets have not disappointed in this regard. There has been tremendous volatility in bond markets all around the world as the on-again, off-again, Fed hike sequence and uncertainty about ECB and BOJ moves has caused wild gyrations in rates, prices and capital flows. We have been disciples of Van Hoisington on the direction of interest rates during this cycle and reiterated last quarter one of the principle tenets of his view that *"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."* The data here is very strong in support of the Hoisington view; there is simply no inflation to be found in any of the developed markets and global interest rates have continued to inch downward despite near universal predictions that they "must" rise. The Fed decision not to hike in September was further evidence of the concerns about DEflation (and bonds rallied hard) so there has been a concerted effort by all the Fed talking heads to promote the idea that QEeen Janet will pull a Lucy in December and yank the stimulus football away. The most recent few weeks have seen some carnage in the short end of the curve and the market expectations for the Fed to raise in December has risen into the 70%s. We will stay with our wingman in this one and Van says the secular lows in interest rates are not in and that long bonds remain a buy. In talking to my version of the "smartest man in Europe" a couple weeks ago (in deference to Byron Wein who would write about his visit with the smartest man in Europe each year), he said he is still very heavily in global long bonds and sees them as a high potential return asset in an investment environment that he believes will get significantly more challenging in the quarters ahead. This view was clearly dead wrong in October and could turn out to be challenging in the short-term if sentiment turns toward believing that rates are headed higher. Until the data changes, we will stick with the thesis that bond markets will judge a rate increase as a policy error that will slow economic growth and that the long end of the curve will rally, making long bonds an attractive investment.

Regular readers of our letters are familiar with our view that broad commodities would continue to be a challenging area to invest in a strong Dollar environment, but that oil would be a unique story related to the Supply Shock that occurred last November when Saudi Arabia decided not to cut production. There are lots of theories on why they made the move to increase production and crater prices, from punishing Russia and Iran, to destroying the U.S. shale industry, but we believe from talking to lots of people in the business that the primary motivation was to slow the growth of alternative energy adoption (particularly solar) as they came to the realization that perhaps there was potential for a hydrocarbon free world and that what they believed was a multi-century asset (their oil and gas reserves) might only be a multi-decade asset and that they needed to gain market share today. Based on this view, we 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."* That huge drop came in Q3 and oil dropped to new lows (hit $38) and all things oil & gas related had a very challenging time. We have been saying "Don't Mess With the Andurand" (Pierre Andurand of Andurand Capital, a play on the movie *Don't Mess With The Zohan*) as his view on oil has been the best of the major fund managers in the space and he thinks we won't see a material strengthening in oil markets until 2017. That view matches up nicely with the timing of the 1985 Supply Shock pattern and unless the Saudis decide to surprise everyone and change their mind again later this month, we would expect that pattern to hold.

Thinking about the broader commodities markets, we wrote last quarter that *"the declaration of the death of the Commodity Super Cycle 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." Being a contrarian in commodities at any point since the downturn in 2011 (coincidently corresponds with the day of the Glencore IPO…) has been a losing proposition, but we are starting to see some signs of life in certain segments of the markets that pique our interest just a touch. We discussed last time how contrary to popular opinion, the Dollar has actually peaked just after the Fed raises rates as those who have front run the move begin to take profits on their positions. We wrote that, *"so with a September lift-off looking more and more likely, maybe the time to start thinking about commodities is approaching"* and we were clearly right to wait to see the whites of the Fed's eyes, since they blinked yet again, but we will reiterate that should they pull the trigger in December, that could be the end of the Dollar rally. Again looking at those pesky facts, despite a really sharp rally in DXY over the past few weeks, it has still not breached the March 15th high, so the "strong Dollar" mantra should really be more like a "weak other currencies" mantra for most of this year. 13D has also done a lot of studying of the commodities trend and found a similar series of failed rallies against resistance in 2013, 2014 and a third attempt here in 2015. Should the CRB Index breach the 200-level there could be some follow though and renewed momentum. Finding anyone who is even willing to discuss commodities as an investment is tough these days and we can hear the words of Sir John Templeton that Bull Markets are born on pessimism, maximum pessimism.

Let's conclude this section by taking a look at some specific ideas that we have discussed this year and some ideas that look attractive in the current environment. When looking back at periods of challenging markets over time there has been an interesting market neutral play that provides some solid downside protection (and can be really effective when markets get truly stinky) and we wrote in the spring *"about how it might be time to play a little defense by going long IWL (large) and short IWM (small)."* When looking back at this trade last quarter we said that having been wrong in Q2 was setting up an even better risk/reward in Q3 saying *"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."* Playing defense was the right call in Q3 as the spread between IWL, down (1%), and IWM, down (6%), was quite wide and the gap closed just as expected. Surprisingly, the small-caps have trailed during the Rocktober surge and the CYTD spread remains at 3% in favor of the large-caps. We continue to see significant risk to the downside in the small-cap indices as P/E ratios are at crazy levels when all of the companies are included. Many sources make adjustments for companies with negative earnings to make the R2000 P/E look more palatable, but we think the unadjusted numbers are more reflective of reality. The one thing that could derail this trade is if the Fed actually does raise rates and the Dollar really surges, the large-caps could actually get hit harder since they have more non-dollar revenue exposure.

Our cautious view on Biotech had been wrong for the first half of the year, but we were able to write in July that, *"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)."* Leaving this sector to the experts was truly a good idea and the volatility has continued unabated as IBB crashed in August and September, falling all the way into negative territory to down (6%) by September 28th, before turning on a dime along with the rest of the market and surging 14% to remain nicely ahead of the S&P 500, up 8% CYTD as of October 31. Presidential hopefuls bashing runaway drug prices and lack of R&D spending, newspapers

making accusations about accounting irregularities and the huge endpoint sensitivity of these stocks makes long-term investing a challenge. We made a point about the challenge of investing in the biotech segment last time saying *"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."* Staying away from this sector over the past three months was advisable as IBB lost (15%) and the big name basket lost (10%), (8%), 0% and (6%) respectively. The valuations of some of the big names are actually pretty attractive with AMGN at a 19 P/E and GILD at 9, so an interesting idea here would be to create a long/short approach by going long the basket and short IBB (either 50% or 100% depending on net long preference). One place where we were completely wrong last quarter was where we wrote *"one other way to play in biotech is to own the toolmakers, like Illumina (ILMN)."* Unfortunately, ILMN missed earnings and collapsed (36%) in August and September. The long-term story for facilitating personalized medicine through genomics is compelling, but there are competitors nipping at ILMN's heels. That said, buying the dominant player in a growth industry when they go on sale has proven to be an attractive strategy, so we would lean toward rebuilding this position at these levels.

The Tech battle between Old (MSFT, INTC, ORCL, HPQ, IBM) and New (PCLN, EBAY, GOOGL, NFLX, FB, AMZN) has been raging for a few years as the smart phone continues to assault the P.C. market and e-commerce and non-traditional media chip away at the old guard companies. The New Tech companies had been trouncing the Old Tech companies all year coming into Q3 when we wrote *"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."* Over the past three months tech was one of the winners (along with consumer) and there were some strong performers on both sides, although the weakest outcomes were in the Old Tech side again. Some big EPS beats at MSFT and INTC pushed those names up 13% and 17% respectively, but ORCL, HPQ and IBM continued their downward paths, falling (3%), (12%) and (13%). Earnings were even more robust in the New Tech pool as FB jumped 8%, AMZN soared 17%, NFLX beat EPS but missed on revenue (and made a silly statement about somehow being related to the new chips in credit cards) so fell (5%), GOOGL cruised up 12%, EBAY was neutral, down (1%) and PCLN continued to perform well above expectations and jumped 17%. We have discussed valuations in tech in other sections and there are some places where things look a little bubbly, but overall the growth is strong and the profitability is very high. However, we will reiterate here that in a general correction, particularly one related to rising discount rates, high P/E stocks will fall more, so this could be a time to even out the portfolio and be more neutral until we get some clarity on the Fed decision in December. There is even a case to be made for the long value (Old), short growth (New) portfolio in this environment as a pure defensive play, but then we would fall back to what we said last time that *"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."*

Since last year, we have made the case that the big U.S. Banks have been "Dodd-Franked" by all of the post-GFC regulations which have essentially turned them into Utilities by restricting their activities and increasing their capital ratios so that they can't lever up enough to generate solid returns in a ZIRP world. We wrote last quarter that, *"the rising consensus that*

the Fed will raise rates in September has investors believing that Net Interest Margins will rise" and the bank stocks had surged in the late summer months in anticipation of the Fed lift off. Unfortunately for the banks, QEeen Janet kept the Fed Funds rate at zero and our view that rates would be #Lower4Longer has continued to hamper bank stocks and they have struggled over the last three months with C down (9%), JPM down (6%), BAC down (6%), WFC down (6%), GS down (9%) and MS down (15%). Interestingly, in the past couple days, Ms. Yellen has started making noises about wanting to be more like Lucy, so banks will rally into the expectation of a Fed rate increase. We would expect economic data to continue to come in weaker than expected in the coming weeks so some of that momentum will fade and we would be apt to "sell the rips" in the bank sector. The biggest reason to be wary of U.S. banks in our minds is the potential for some meaningful losses on their loans into the energy industry (particularly the shale oil sector). We wrote last time that *"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."* A lot of money was raised early in the year to buy the distressed debt of energy companies betting on a quick oil recovery, but the stubbornness of oil below $50 is putting some real pressure on those overleveraged balance sheets and we also wrote how *"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."* The October reset dates have come and gone and it appears the banks have once again kicked the can (or better yet, the oil drum) down the lane and that we won't see any real pain until the New Year. Only time will tell whether slightly higher NIMs (IF the Fed ever does raise rates) can offset the sins of lending to the oil patch at $110 oil when oil remains at $45, but even if the big blowups are avoided somehow, we still believe upside is capped for U.S. banks and there are much better places to buy financials around the world.

Despite the poor returns in Q3 for the Japan Mega Banks, SMFG down (14%), MTU down (12%) and MFG down (8%), we still side with our favorite Japan managers in NYC and London who see significant upside for these under leveraged assets. One of the main stories here is the unwinding of cross shareholdings, which continues apace, and the ability to expand lending into the fast growing regions of China, India and Africa. We have to admit we were seduced by the recovery story that our London manager pitched us on the European banks and we said last time that *"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."* We intentionally use the word seduced, because the outcome during Q3 was so bad that we are feeling a little lovesick. The French banks fell (20%) and (7%), respectively, the Spanish contingent dropped (15%), (6%) and (16%), respectively and the Italian cohort slipped (14%), (8%) and (13%), respectively. It was an ugly quarter all around for developed markets financials and even our suggestion that you could diversify a little in an ETF if you didn't want to rifle shoot, *"you can also buy baskets of these banks in DXJF and EUFN",* failed to offer any real protection, falling (11%) and (9%), respectively. We were with our managers in London just a few weeks ago and they were pounding the table on these names, so we will stick with the theme and buy more of these names as they have begun to rally again in anticipation of a Fed move in December.

We spent a lot of time on the consumer sector above, but one specific 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 2015 had been significantly less good and *"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 and the low valuations got*

lower as fears of price wars, 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)." Investors must have finally gone to an airport this summer and seen the amazing crowds, as the airlines finally took flight again with AAL up 15%, UAL up 7%, DAL up 15%, JBLU up 8% and LUV up an astonishing 28% (largest crowds by far at places like Midway in Chicago). These moves pushed the basket back above the S&P 500 for the CYTD, but the results are mixed as American and United are still down, while Delta and Southwest are up slightly and JetBlue has soared this year, up 65%. The airlines are still "stupid cheap" with P/Es that are almost unbelievable, LUV at 17, DAL and JBLU at 15, AAL at 6.5 and UAL at 3.5 (not a mistake on the decimal). The airlines are so flush with cash they are paying down debt at an astonishing rate and if public markets investors don't start buying, it is highly likely that some private equity funds with dry powder may take these companies private. The one risk we are mindful of we discussed last time is that *"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."* We do see rising risks of a Recession in 2016, so we need to keep an eye on traffic volumes and PRASM numbers, but the margin of safety in these names is very high which makes them attractive in the current environment.

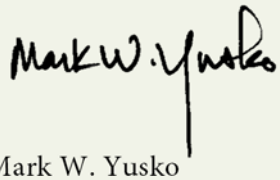
An area that we have written about, but failed to take advantage of this year, has been the Defense sector and we set the stage by saying *"with tensions rising over the pending Iran nuclear deal, intermittent flare ups from ISIS and other terrorist groups and increased rhetoric between China and Japan, there has been renewed interest in defense companies."* The resumption in U.S. defense spending growth next year has created a tailwind for these companies over the past few quarters and the stocks rose again in the past three months with NOC up 9%, GD flat, LMT up 6% and BA up 3%. We added EADSY to the list last quarter and despite a roughly flat period recently, one of our favorite European managers has made this their largest position and we have heard rumblings of some major contract announcements coming soon. In summarizing a positive view on defense, we said *"as the world continues to grow 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."* Another way to think about this sector is that playing Defense with Defense makes sense since many of the potentially disruptive events that could hurt other equity markets would provide opportunities for these companies to increase profits by offering solutions.

In thinking about global changes we have found a number of place to get really excited about in recent months and see some compelling opportunities to deploy capital as those changes unfold. In Argentina, the elections have finally begun and the first round could not have gone better for reform minded investors like ourselves who favor the pro-business candidate, Macri over the Kirschner-selected Scioli. As expected, Scioli had the most votes in round one, but his margin of victory was so small that the split of the third place votes for Massa could give Macri an edge in the December runoff. We have built a basket of PAM, YPF, GGAL and BMA and while these stocks are up a lot in the past couple of months (50%, 7%, 37% and 30% respectively), we would expect to see very significant gains next year as the debt holdout issue is settled and the capital markets open up for Argentinian companies. We also see tremendous opportunities in China and will do a deeper dive next quarter, when we update the 10 Surprises, but we see two compelling near term opportunities. First, the MSCI China Index is going to add 14 China ADRs this month and that will bring large flows into those names and will raise awareness of these companies relative to their U.S. and global peers. Names like

BIDU, BABA, JD, CTRP, NTES, VIPS, QIHU, WUBA, ATHM, EDU should benefit greatly from being added to the Index and it is nice that all of these happen to be related to one of our favorite themes, China e-commerce. Given we are just a few days away from Singles Day (#1111Fest), the Chinese equivalent of Cyber-Monday, we would expect these names to continue their strong performance of recent weeks in the months ahead. Secondarily, the increased attention to China A-Shares is likely to pull capital back into the China market and we would expect to see ETFs and CEFs like ASHR, CHNA and CAF perform well.

So there we have it, a Market Outlook that reflects that fact that A.W. Jones was indeed right, it is time to get hedged. While there are myriad opportunities all over the globe, the risks to the global economy suggest that we should shift toward a portfolio dominated by strategies and positions that favor Alpha over Beta, manager skill over passive indexing and illiquidity premiums over public valuations. We concur with the prospective view of capital market returns voiced by great firms like GMO, Research Affiliates, AQR and Vanguard that the traditional 70/30 stock/bond portfolio will struggle to make anything beyond low single-digit returns, returns that will not even come close to meeting the needs of institutions, wealthy families and individuals. Just like in 2000, there are plenty of opportunities to make solid returns, but they require venturing outside the comfort zone of traditional investments and resisting the siren song of market prices that lure investors into buying what they wish they would have bought and selling what they are about to need. As Mark Twain said "the reports of my demise have been greatly exaggerated" and once again, like in 2000 and 2008, the reports of the demise of hedge funds have been greatly exaggerated and this is the time to embrace the wisdom of Alfred Winslow and become a Jones that no one can keep up with.

With warmest regards,



Mark W. Yusko
Chief Executive Officer & Chief Investment Officer

General

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

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

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

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

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

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

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

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

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

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

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

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

MSCI Emerging Markets Index — this is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. 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.