4/15/14

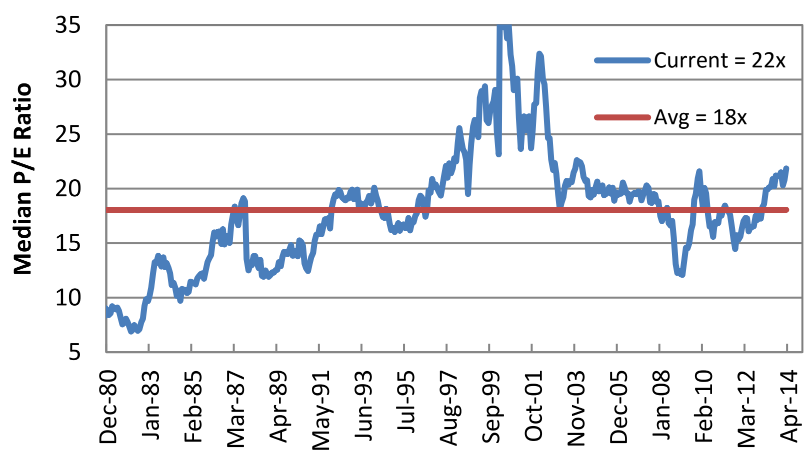
Dear Clients & Friends,

The most common question we are hearing from clients is: "Given near record highs in the major market indices and signs of excessive market valuations, what's the best strategy going forward?" In other words, my portfolio's up and I'm happy, but I don't want to lose it! What do I do?

We think the best way to navigate this environment is by finding great individual investments and avoiding overvalued areas. Our strategy of investing in companies with strong market positions, low debt levels, proven management, and low valuations gives us the right balance of potential growth and downside protection.

In aggregate, U.S. stocks now trade above historical levels due to low interest rates and elevated levels of investor optimism. Investors Intelligence reports three bullish investors for every bearish one. Consequently, the median price/earnings (P/E) ratio on large cap stocks is roughly 22x versus a historical average of 18x. The small cap index trades even higher at 30x earnings versus a historical average of 22x. See Chart A below. Fortunately, we are not limited to just buying the whole U.S. index.

Chart A: Large Cap U.S. Median Price/Earnings Ratio (NDR Calculation)



Although people often refer to the "stock market" as if it's one independent thing, there are about 5,000 publically traded companies in the U.S. alone. Our job is to construct a portfolio of 30-40 securities that meets our strict criteria. While it takes some digging, we believe we've constructed portfolios of good companies trading at reasonable valuations and can deliver good performance going forward.

Part of our historical investment success has been from avoiding trouble. In the late 90s, high valuations dissuaded us from owning overvalued internet stocks during the dot.com bubble. In 2007, commodity price spikes including $150 oil drove us to avoid many commodity companies. In 2008, excessive leverage and suspiciously high profitability levels had us avoiding large financial stocks. Today, we see excessive valuations in social media, biotechnology, the IPO market, and even broad-based small cap ETFs that are heavily comprised of high-multiple small cap growth companies. We think avoiding these overvalued areas will mitigate risk, but the key is finding successful investment opportunities.

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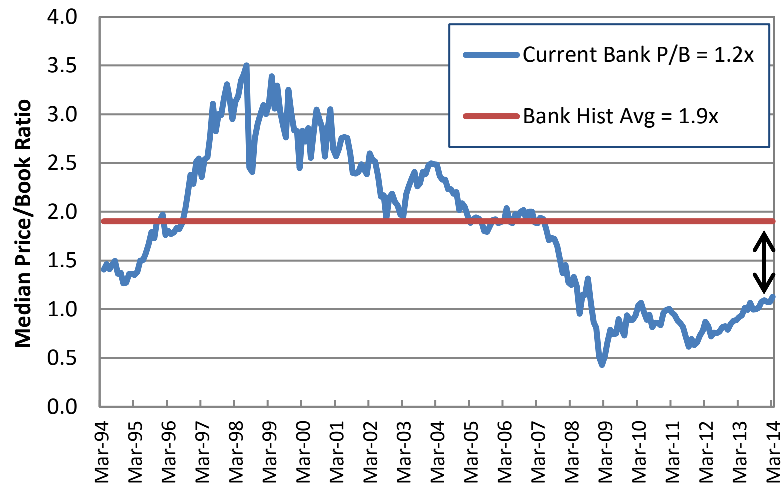
Our investments are focused in areas where we see pockets of value. For example, banks still trade at only 1.2x book value versus a historical average of 1.9x and at a discount to the overall S&P 500 valuation level. See Chart B below.

Chart B: Bank Stocks Price/Book Ratio



With the potential combination of an improving economy, strengthening real estate market, pick up in loan demand, and a hotter M&A environment, we think bank stocks could revert back up to their historical valuation level.

Along with financials, we think good returns can still be achieved in many other sectors such as media, telecommunication, and autos as well as in other countries. Some emerging market countries dramatically underperformed U.S. stocks last year resulting in some compelling investment opportunities. As a group, emerging markets now trade at roughly half U.S. valuation levels. Since we are in the process of taking advantage of some of these themes and accumulating specific securities, I will postpone the detailed investment case for future letters. In the meantime, we will continue to work hard to find and acquire more opportunities that meet our strict investment criteria.

If you have any questions or particular issues you would like me to discuss, please don't hesitate to contact me at tom@eidelmanvirant.com.

Sincerely,

Tom Eidelman, CFA
Vice President