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CAPITAL

Quarterly Letter **September 2014**

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Dear Clients & Friends,

Global equity markets experienced renewed volatility in the third quarter, exemplified by a 7.4% decline in the Russell 2000 small cap index. The S&P 500 large cap index actually gained 1% for the quarter showing a big performance divergence between large and small cap stocks. Such declines were attributed to the potential spread of the Ebola virus in the U.S., a European economic slowdown, declining oil prices, potential rising U.S. interest rates, Russia's involvement in Ukraine, protests in Hong Kong, and ISIS in Iraq. These events have taken a toll on investors who were extremely optimistic just a few months ago. The good news is that the recent sell off has "normalized" sentiment and created more attractive stock prices. We remain optimistic for the stock market and our clients' portfolios and view the recent market selloff as an opportunity to trade into equities with an even better risk/reward profile.

The energy sector experienced sharp declines from recent highs due to oil prices falling from $100 to $80/bbl. The current oversupply of oil is due to weak demand from Europe and China combined with outstanding oil production from the United States. New fracking technology has enabled a near doubling of U.S. production mainly from shale rock areas in North Dakota (Bakken) and Texas (Permian & Eagleford). This "shale revolution," as it is often referred to, is a fantastic development for the United States as it lowers gasoline prices for consumers, creates a competitive advantage for some industries, creates millions of jobs, and increases our national security by relying less on imports from volatile and unfriendly countries. We think global energy demand will return and be supportive of higher energy prices in the longer term. Current weakness in energy stocks could be a buying opportunity to position ourselves for an eventual recovery.

We remain optimistic on equities, especially relative to the extremely low rates on bonds. In order to meet their spending needs, we continue to think that individuals and institutions will need more exposure to equities relative to fixed income and this should keep stock valuations high.

Our goal is to help our clients' portfolios achieve higher returns with less downside risk. To achieve this goal, we are looking to construct a "Dream Team" investment portfolio. While there are literally hundreds of factors we consider before making an investment, in the following letter, I'll talk about the four key factors we look for in our ideal investment.

Sincerely,

Tom Eidelman, CFA

THE “DREAM TEAM” INVESTMENT PORTFOLIO

Who can forget the 1992 United States men's Olympic basketball team, nicknamed the "Dream Team." It was the first American Olympic team to feature active NBA players. Michael Jordan, Larry Bird, and Magic Johnson formed the heart of the original team and it was touted as the greatest sports team ever assembled. Outlined in the documentary, “The Dream Team,” the four USA coaches taught these superstars to work together and make the whole team even stronger than the sum of its parts. The result? The Dream Team defeated its opponents by an average of almost 44 points en route to the gold medal at the 1992 Summer Olympics held in Barcelona, Spain.

Just as the dream team was the best way to construct a basketball team with the best chance of winning the gold, we are looking to construct a dream team investment portfolio. Instead of investing in all 5000 publically traded U.S. stocks via an index fund, we think the best way to deliver superior investment performance while incurring less risk is to focus on the best 30-40 securities we can find. So what are the key characteristics of the all-star stock we are looking for?

- Great Management
- Competitive Advantage
- Strong Financial Position
- Attractive Valuation

Great Management

Like having a great coach, investing in companies with great management is paramount. Since management is so important to the future success of a company, we not only evaluate their results and read their plans, but often meet with them face-to-face. This year alone, our investment team has personally met with over 100 management teams. What are we looking for?

We usually begin our interrogations with a seemingly trivial question: “Can you describe the company’s corporate culture and management style?” When you ask a *great* management team this question, their faces light up like a Christmas tree. They can’t wait to tell you about their corporate missions, employee development, bonus structures, innovation, and laser focus execution. Average management teams shrug their shoulders and essentially describe the way the company has always been run.

When I worked for Microsoft in 2000, you could feel passion and energy from every employee in the company. We wanted to work hard and win for the betterment of ourselves, our team, the company, and even society at large as we innovated to make life more productive and fun for our customers.

We are looking for management with similar passion who properly motivates every employee in the company and ties their compensation to the profitability of the company. This creates a win-win situation for employees, management, and shareholders.

We are also looking for opportunistic management teams that are responsible stewards of shareholder capital. Such managers may buy back their stock when it gets cheap, acquire competitor assets & talent and make decisions that are in the best interest of long-term shareholders. Conversely, acquisitions outside of core products and geographies or just overpaying for other companies at the peak of a market cycle can destroy value.

In the end, the best management teams do all the little things right and measure everything. In our experience, management teams that have specific plans to indentify, track, and improve everything have been the most successful.

Competitive Advantage or Niche

We look for companies that have a competitive advantage or market niche that enables them to achieve sustainable success. While height, strength, shooting and jumping ability were Michael Jordan’s strengths, a company can enjoy economies of scale, branding, network effect, switching costs, patents, resource rights, or regional dominance to fight off competitors.

Warren Buffett has always explained this concept using the analogy of “moat” around a castle. Every company should have a reason that another company couldn’t start up the next day and compete away their business. We want to invest in companies where we think “we sure wouldn’t want to compete against them!”

Strong Financial Position

We look for companies with a strong balance sheet. A strong balance sheet includes low debt levels, little need for outside financing, and abundant tangible assets. Similar to having a cash position in an investment account, a conservatively financed balance sheet gives a company options. In addition to providing insurance against a downturn, giving customers confidence in your ability to pay, and improving credit ratings and interest rates, a clean balance sheet gives management flexibility to take advantage of opportunities to make acquisitions, buy back stock, or increase dividends. On top of all that, well financed companies are more likely to get acquired.

In addition to a strong balance sheet, we look for companies with a sustainable and healthy return on equity (ROE) and free cash flow generation. Having said this, we are skeptical of companies with returns on equity that are *too* high, especially when it is a commoditized business. Many industries have good times and bad times, and we need to be careful not to invest at the peak of a cycle when a company is temporarily earning a high return. If a company has a very strong management or competitive advantage, it may be able to maintain high levels of profitability.

Attractive Valuation

A company's product and management team may be outstanding, but is the stock worth buying? Here in St. Louis, we got a great example when the Cardinals had to make a decision regarding our multiyear MVP Albert Pujols. There was little doubt that he would continue being a good player, the question was whether he was worth paying $24 million per year for 10 years starting at the age of 31. In the stock market, social media giant Twitter (TWTR) will likely grow revenues and earnings at more than twice the market average, but the question is whether it is worth paying over 100x 2015 estimated earnings for such performance. Paying the right valuation for a stock is critical.

Numerous studies have shown over different time periods and geographies that low valuations (as measured by P/E, P/B, or P/CF ratios) have been correlated with higher future returns. Chart A shows that over time, stocks in S&P 500 with the lowest P/E ratios have drastically outperformed those with high P/E ratios. See chart on next page.

Returns to S&P 500 Stocks Ranked by P/E Ratio (1957-2012)

PE Ratio	Annual Return
Lowest	12.9%
Low	12.3%
Average	10.3%
High	9.2%
Highest	7.9%

Being a "value investor" doesn't mean buying poor performing companies at cheap prices, it means buying companies at a discount to what we think they are ultimately worth. We are looking to buy great companies at attractive valuations.

Conclusion

Our goal is to construct a "Dream Team" investment portfolio in order to give our clients the best chance to achieve superior investment returns while minimizing downside risk. While great management, a competitive advantage, strong financial position and attractive valuations are key factors we look for, it barely scratches the surface with regards to describing our rigorous research checklist. Every day we are digging through financial statements, listening to earnings calls, and speaking with management teams in order to find all-star investments. We think our "Dream Team" portfolio gives our clients the best opportunity to achieve their financial goals.

Disclosures

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