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Richard Bregman, *Chief Executive Officer*

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Dear Clients and Friends:

Earlier this year, I drove with my wife and son from New York City to Lenox, Massachusetts—about a 3 hour drive—to attend a family friend's 50th birthday party. The most direct highway route is to go north from Manhattan on the Taconic Parkway up to the Massachusetts Turnpike, then go east to Lee, Massachusetts and 3 miles on a local road to Lenox: a 154 mile drive from our apartment (according to Mapquest.com). However, I chose an alternate route: rather than the Taconic, I took the New York State Thruway up to the Massachusetts Turnpike. Roughly parallel to the Taconic, the Thruway takes you a little bit west before heading back east on the Mass Pike towards Lenox, adding about 26 miles to the drive.

Taking the Road (More or) Less Travelled

Why go 26 miles out of our way? Because although on the map the Taconic is technically more direct, on the ground it is actually a narrow, winding, dimly lit state highway—never mind the 55 mph speed limit and large contingent of state troopers eager to give speeding tickets to downstate motorists intruding (unintentionally, of course) on the upstate serenity. In comparison, the Thruway is a relatively wide and straight Interstate, with a 65 mph speed limit most of the way and (in my experience) fewer speed traps than the Taconic.

Those details do not appear on the map. I have driven both routes many times;[1] in my personal experience, both take approximately 2 ¾ hours.[2] So even though the Thruway adds distance, it does not add time and makes for a more pleasant drive to the same destination.

Turn to Investing

How many roads are there to your investment destination? Where will they take you, how long will the journeys last and will they be pleasant rides? Do the maps give you all of the information you need? Road maps are essentially fixed representations of the past; they do not predict current conditions.

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[1] My son is in his eighth year going to summer camp two towns over from Lenox.

[2] Mapquest.com calculates the New York to Lenox trip via the 26-mile longer Thruway route at 3 hours and 23 minutes and the Taconic route at 3 hours and 19 minutes. I am not surprised that the times are comparable, as they confirm my personal experience, but query: how exactly do they come up with those figures?

So it is with "investment maps": the historical charts on which so many investors base their decisions and which, as with road maps, are not highly predictive of current or future conditions.

At MJB Asset Management, we want to get you to your investment destination with as smooth and pleasant a ride as possible. For that reason — although we of course look at maps when charting our general course — we strive to make our investment decisions while actually driving on the ground, in the present moment. We do it for the same reason you keep your eye on the road while driving: the future is unknown. Conditions can change rapidly, without warning and without regard for what the maps say. (Consider a lightning-struck tree falling down and blocking the road, or, in the world of investing, a peripheral European country suddenly not being able to pay its bills, resulting in a global stock market sell-off.) The map can tell you a blind curve is up ahead, but it cannot tell you what is behind the curve—perhaps open road but perhaps an oncoming tractor-trailer. The only way to know with certainty is to drive the road and take the curve. From this perspective, navigating the investment journey requires caution, attention to current investment conditions and, most importantly, flexibility to adjust course in a way that keeps the investor moving safely and smoothly toward his or her longer-term destination as conditions change. Such flexibility might include—as it did with my drive to Lenox— taking a course that appears to be out of the way so that the overall ride is safer and more comfortable.

That is exactly what we have been doing in our portfolios for the past few months. To protect against the possible "tractor-trailer" scenario, we incorporate in every portfolio a variety of so-called hedging and absolute return strategies, i.e., investment strategies designed to make gains independent of the market. Because such strategies move independently of the markets, they offer the potential for protection during down markets. Even if they happen to move in concert with the market during a downdraft, hedging strategies have protections in place that tend to limit the amount of downside movement. Figuratively speaking, if there is an 18-wheeler coming around the blind curve, it might force us to the side of the road as it comes around, but we will avoid a head-on crash. The flip side is that if, on the other hand, there is open road behind the bend, we will still be travelling safely, though a bit below the speed limit due to our caution (and will therefore likely miss the thrill that the speedier, more risk-happy drivers experience.)

<u>What is currently behind the bend?</u>

We do not know with certainty what lies ahead. Factors suggesting "open road" behind the curve include: a generally (albeit slowly) improving economy; a decline (again, albeit slow) in unemployment; strong corporate balance sheets; and good corporate earnings. Factors suggesting a "tractor-trailer" include: continued high unemployment (is the glass half empty or half full?); a lingering weak housing market; actions taken by many emerging market governments, including those of China and Brazil, to actively slow economic growth in their countries; rising food and energy prices; a weak U.S. currency; and economic malaise in Europe with the possibility of an economic meltdown in the peripheral European countries.

In the background of this scenario, the U.S. government has been desperately attempting to inflate the U.S. economy by holding interest rates at record lows for an extended period. One plainly observable consequence is that savers can no longer earn meaningful returns on CDs and money market funds, leading many of them to seek higher returns elsewhere and thus taking on more risk than they might imagine. Though there is no way to know for certain, it appears that this flow of money into riskier investments is at least partially responsible for the jump in the prices of emerging market stocks and bonds. We see this as “hot” money and do not want to be around when it flows elsewhere.

In light of this uncertainty, we have maintained an overweighting in our hedged positions. This position has hindered our returns in the past several months, as equity markets around the world have largely ignored the plentiful weak economic news and continued to rise. Of course, we have positions in the stock market as well and they generally have fared well in this environment[3]; however, as with the driver carefully navigating the potentially dangerous bend in the road, our hedging strategies have held us to a steadier, somewhat slower pace during several of the recent market bursts. We recognize that all investors, including us, will periodically be at odds with market movements. However, we continue to believe that large risks remain in the market and we are confident that our hedging strategies will protect our clients’ capital when the broad markets begin to reflect some or all of those risks.

In the meantime, if your investment destination (or the road you wish to take there) has changed, please let me know. We can then make any necessary adjustments to your portfolio. Thank you for your trust. I look forward to speaking with you.

Sincerely,

Richard Bregman

[3] Two stock-oriented funds that have significantly underperformed the market and their peers in the past three months are the Fairholme Fund and the Evermore Global Value Fund. We have lost confidence in the manager of Fairholme and are systematically removing it from client portfolios. We continue to have confidence in Evermore’s manager; the fund’s short-term underperformance is due to several holdings in Europe that have been disproportionately affected by the news surrounding the Greece bailout. I have spoken with the manager and believe that the impact is short-term. Nevertheless we will continue to monitor the fund closely.