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Perihelion, Paradox, Predictions *continued from page 1*

American producers are also at or below breakeven. Consequently we expect some reduction in crude output as the year unfolds and the iron laws of economics weigh on marginal producers. Eventually production cuts will put a floor underneath oil prices (as will increased oil consumption as users respond to the lower prices). We just don't know "How low is low?" or "When will prices stabilize?" nor does anyone else. Of course we must always remember that oil has a strong geopolitical dimension so any threat of war in the Middle East, the Ukraine, or elsewhere could quickly propel oil prices higher regardless of the current supply/demand conditions.

2015

Turning now to 2015, we will be especially alert for unfolding developments in the following areas: 1) Foreign exchange volatility as Europe and Japan try to further devalue their currencies; 2) Signs that China's economic growth is decelerating dramatically; 3) The upcoming election in Greece which might bring an anti-austerity, anti-Euro coalition into power and raise the spectre of Greece abandoning the Euro; 4) Secondary and tertiary effects from the decline of energy prices on industries such as autos, airlines, hotels, retailers, and chemicals.

Foreign exchange volatility can unsettle financial markets particularly if countries engage in competitive devaluations. For example, as the Japanese yen depreciates, products priced in Korean won, Chinese yuan, or Thai bahts become less competitive globally. Will those governments remain passive while their Japanese competitors take market share from them? "Beggar thy neighbor" currency wars could result in a replay of the Great Depression's policy errors.

China was the economic engine of the post-2009 commodity boom which provided a tailwind to resource economies such as Australia, Brazil, and Chile. Although the boom is certainly over, any further weakening in China's growth rate could put intense pressure on those economies. In addition, weaker growth could cause social unrest inside of China itself.

The January 25th Greek election pits the relatively moderate government of Antonis Samparas against the radical left SYRIZA party of Alexis Tsipras. The Greek economy has shrunk 25% since 2008 and it remains in deep depression. Resentment against the austerity imposed by the European Union and the European Central Bank is high. A SYRIZA victory could lead to renewed strains on the European financial system and cause contagion among other weak economies such as Spain and Italy.

The fall in energy prices impacts every industry, some favorably, some unfavorably. The longer low prices persist the greater the "ripple effects" throughout the global economy. For example, airlines' fuel costs have gone down. That's great for their profitability, but will lower costs reduce their incentive to buy more fuel efficient aircraft? If so, what does that mean for aircraft manufacturers' profits?

We could list more developments that merit close monitoring, but the four above are the key ones on our radar screen as we enter the New Year. As always we will pay very close attention to valuations in the market and seek out investments which have favorable risk/return characteristics. We cannot predict the future but we can try to assess probabilities and risk. We look forward to serving you in 2015. Happy New Year!

-Bill Miller, CFA

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Perihelion, Paradox, Predictions

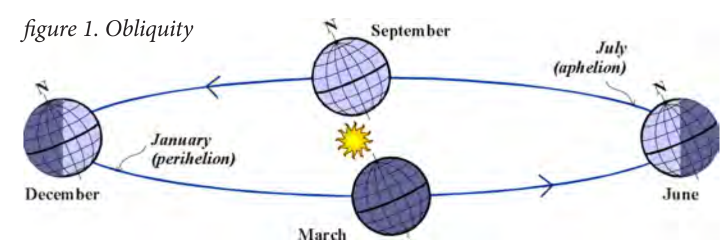
Bill Miller, CFA
Patton Albertson & Miller, LLC

On January 4th the Earth made its annual closest approach to the Sun, an event astronomers call "perihelion" (from the Greek word *peri* meaning "near" and the word *helios* meaning "Sun"). Many people in the Northern Hemisphere are surprised to learn that our planet's slightly elliptical orbit always brings it nearest the Sun in early January, the middle of winter. Commonsense suggests to them that perihelion should occur in summer because that is when the weather is warmest. Earth is about 91.4 million miles from the Sun in January compared to 94.5 million miles in early July when it is furthest from the Sun, "aphelion".

Paradoxically, Earth's distance from the Sun has nothing to do with the timing of our seasons, something called "obliquity" does. Obliquity is the tilt of the Earth on its axis relative to the path of its orbit. See figure 1. Currently Earth has a 23.4 degree tilt although that angle varies a few degrees over tens of thousands of years with significant global climate effects. In January the Northern Hemisphere is tilted away from the Sun causing less solar radiation to strike the hemisphere which in turns means lower temperatures. It is our wintertime. Conversely the Southern Hemisphere in January tilts towards the Sun so it is summertime down under.

So the regularity of the Earth's celestial mechanics, once understood, explains the predictability of the seasons. If only the economy and financial markets were as predictable! Unfortunately the interactions of billions of human beings driven by diverse and often conflicting objectives confound attempts by economists and market strategists to explain what is happening much less to predict what will happen. Nevertheless, pundits play the game each New Year of writing a list of their top 5 or 10 predictions for the coming year. We will resist the temptation and instead take a retrospective look at some of 2014's surprises and suggest a few developments to watch out for in 2015.

figure 1. Obliquity



2014 Surprises.

As the management guru Peter F. Drucker once said "Trying to predict the future is like driving down a country road at night with no lights while looking out the back window." 2014 convincingly demonstrated that predicting major events accurately is probably beyond the skillset of most mortals. For 2014 Wall Street's 20 top strategists unanimously predicted interest rates would rise (bond prices would fall) due to the Federal Reserve's termination of "quantitative easing" ie. money printing. The Fed indeed ended QE by the end of October, but a baffling thing happened—interest rates declined over the course of the year. The 10 year U.S. Treasury bond , for example, fell from 3.04% in January to just 2.07% by year end meaning bond prices rose. The bond had a total return (coupon income plus capital appreciation) of over 11%, easily beating the Dow Jones Industrial Average which gained 10%.

Although we are by nature contrarians, the 2014 consensus bond forecast made sense to us so like many portfolio managers we shortened bond maturities and sought "bond alternatives" to reduce our clients' exposure to rising interest rates. Those actions obviously did not enhance bond portfolio performance in hindsight.

For 2015 Wall Street's median forecast calls for 10 year Treasury yields to reach 3.01% by December 2015 compared to about 2% currently. In essence strategists are moving their 2014 predictions into 2015. We don't share that expectation this year because we see some important changes from a year ago. U.S. bond yields represent greater relative value compared to the 10 year yields available in Europe and Japan (Germany 0.48%, Switzerland 0.19%, Japan 0.31%).

We anticipate strong foreign demand for our bonds which will help keep a lid on domestic interest rates, at least for most of the year. We are investing accordingly.

The collapse of crude oil prices in the second half of 2014 was another huge surprise. The benchmark West Texas Intermediate Crude price started 2014 around $95 per barrel. By year end it had cratered to less than $54. Nobody saw that coming; in fact, most strategists expected crude oil to remain around $100 per barrel (plus or minus $10) as it had since early 2013. A combination of weak global economic growth, sharply higher U.S. oil production due to fracking, and Saudi Arabia's determination to protect its global market share precipitated the oil price collapse. The S&P 500 Energy sector declined 7.8% in 2014, the only sector with negative returns for the year.

Crude oil prices are now well below the cost of production in many countries including such important producers as Nigeria, Venezuela, and Russia. Many

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Jimmy Patton
Patton Albertson & Miller, LLC

Absolutely

In her article "Why Do Women Hate Their Bodies?" Carolyn Coker Ross, MD wrote:

> "Today, the media is a far more powerful influence than ever before, sometimes taking precedence over friends, family or other real women. Whereas women used to look at role models who were average-sized, women are now comparing themselves with images (some of which are merely computerized conglomerations of body parts) that are unrealistically thin. In the old days, a young girl grew up wanting to look like her mother or best friend. Now she wants to look like Angelina Jolie. The more an individual is exposed to the media, the more he or she believes it is reflective of the real world. What most people still don't realize is that the majority of the pictures they see in magazines are altered in some way and that looking like their role models is physically impossible..."

I agree with Dr. Ross; rather than compare themselves with Angelina Jolie, young girls would be much better off if they aspired to simply live a healthy lifestyle. Eating a well-balanced diet, getting some form of exercise each day, reading the newspaper daily, and devoting themselves to their studies would be a much better aspiration. Rather than compare themselves to a moving target conjured up by Hollywood they would be better off aspiring to a fixed goal.

At Patton Albertson & Miller, we believe financial well-being and investing works the same way. Just like the young girls who want to be like Angelina Jolie, we see many investors compare themselves to "Wall Street" in the form of the S&P 500 Index or the Dow Jones Industrial Average. Just like the young women who hate their bodies because they don't stack up to their role model, we see investors who are always chasing returns so they can "keep up with Wall Street." They are constantly chasing the next big idea or the next hot tip.

Rather than chase the Dow or the S&P 500 we think there is a better way. We like to understand what a client's savings is to be used for and when they will need it back. This is what Stephen Covey called "begin with the end in mind." In Wall Street jargon, this is called "Absolute Return". Comparing the performance of your portfolio to indexes such as the Dow or the S&P 500 is called "Relative Return."

Absolute Return is simply the return an investment achieves over a certain period of time. If I invest a dollar on January 1st and on December 31st (one year later) it is worth $1.10, then my absolute return is 10%. Relative Return compares that same result to a benchmark – in the investment world the most well-known benchmark is the Dow Jones Industrial Average (the "Dow"). If in that same one year period, the Dow went up 15%, then the relative return for that investment was -5%. Relative returns are simply your absolute return compared to some benchmark. Relative returns are fine when the market is up but who wants relative returns when the market is down. In 2008, you would not have been happy with a 30% decline in your investment portfolio even though your relative return was positive 8% (the S&P 500 was down 38% that year).

Your relative return was positive 8% but you still lost 30% - not a very comforting consolation.

We believe a better long term outcome will result from steady, reasonable returns over a long period of time. Some call it the Tortoise approach from Aesop's well known fable. But that approach means you must reduce the risk of your portfolio – take a more conservative path by investing in securities that have less risk. Sounds good in 2008, but are you willing to stay the course with that strategy in 2009 when the S&P 500 was up 23% and your portfolio was up only 9 or 10 percent? Absolute return investing means you have to be willing to give up some return in the good times for safety when the storm clouds gather. Unfortunately, you can't have it both ways – you can't have all the upside without participating in the downside.

At Patton Albertson & Miller, we believe that Absolute Return investing will produce superior results over time. We don't aspire to be Angelina Jolie, we just want to live a healthy investment lifestyle.

-Jimmy Patton

Alternatives Stumble in 2014

Keith Jaworski, CFA
Patton Albertson & Miller, LLC

One of the strategies we used in 2014 to reduce risk and produce "Absolute Returns" (see Jimmy Patton's article titled "Absolutely" on page 2 for a description of what we mean by absolute returns) was the use of mutual funds which invest in "Alternative Investments." Alternative investments are generally considered those not included in the three traditional asset classes (stocks, bonds and cash). Alternatives usually have a "low correlation" meaning they move independently of the other asset classes. The expectation is alternative assets might produce a satisfactory return even when stocks and bonds are performing poorly. Of course those expectations are not always met, 2014 being an example.

Often considered the domain of the best and brightest minds of the investment industry (and certainly the most highly compensated), hedge funds (a sub-set of alternative investments) struggled in 2014. The hedge fund industry covers a very broad variety of investments and strategies from commodities, precious metals, real estate, and foreign exchange to convertible bond arbitrage, long/short equity investing, and merger arbitrage. If there is a potential way to make money there is probably a hedge fund trying to do it. "Most hedge funds have not performed extraordinarily well," said Stewart Massey, chief investment officer at Massey Quick & Co. in Morristown, New Jersey.

He expects that redemptions will hit small-and medium-sized hedge funds this year, reducing assets to a level where "they will have to make a decision whether to carry on or not." Tough decisions are ongoing for larger hedge funds as well.

Hedge funds, on average, returned just 2 percent in 2014, their worst performance since 2011, according to data compiled by Bloomberg. Consider these results from some of the "rock stars" of the hedge fund industry:

- John Paulson, famous for shorting leveraged housing assets in the 2008-2009 meltdown, was among the biggest losers in 2014. His $19 billion firm, Paulson & Co., lost money in both Fannie-Freddie and AbbVie-Shire trades. His Advantage fund plunged 14 percent in October and lost 36 percent in 2014
- Brevan Howard, one of the largest hedge funds in Europe, has recorded its first ever annual loss since its inception in 2003. The firm's primary macro fund, the Brevan Howard Fund, lost 0.82 per cent in 2014, according to a letter leaked to investors. The $24bn fund – run by co-founder Alan Howard – was down 0.15 per cent in December and had lost money in nine out of the last 12 months. In recent years, Brevan Howard has been one of the top performing hedge funds, growing assets under management from $12.5bn in 2007 to $40bn by the end of 2013. But last year it proved to be one of the toughest for hedge fund performance since the onset of the financial crisis in 2008 and macro hedge funds – which bet on major economic trends across a range of asset classes including stocks, bonds and currencies – have particularly suffered.
- Guggenheim Partners has slashed personnel at an internal hedge fund that hasn't lived up to big expectations. The $220 billion asset management and investment banking firm cut at least eight senior employees in December at Guggenheim Global Trading, a roughly $600 million hedge fund unit based in the New York suburb of Purchase. The layoffs come amid mediocre performance and little success attracting external clients at GGT, which is led by RBC and Guggenheim fund of hedge funds veterans Loren Katzovitz and Patrick Hughes.
- Some commodity strategies have also struggled as oil prices have tumbled. Hall Commodities LLP, a London-based $100 million hedge-fund firm run by Tony Hall and Arno Pilz, told clients in October it's shutting down after less than two years, citing poor performance.
- Josh Berkowitz's Woodbine Capital Advisors LP said that it was closing down after assets dwindled to $400 million from a peak of $3 billion four years ago.
- Keith Anderson's Anderson Global Macro LLC and Kingsguard Advisors LP, started by two former Goldman Sachs Group Inc. traders, both shut after less than three years in business.

As many managers post disappointing returns, hedge funds are shutting down at a rate not seen since the financial crisis. Chicago-based Hedge Fund Research Inc. reported 461 funds closed in the first half of 2014. If that pace continued, 2014 will have been the worst year for closures since 2009, when there were 1,023 liquidations.

Despite the challenging markets, the hedge fund industry did produce some exceptional returns in 2014. Bill Ackman's Pershing Square Capital Management produced a gain of 32.8% and Quantedge Global 32.3%.

Sophisticated investors, as noted earlier, use hedge funds and other forms of alternative investments as a risk management tool. Institutional Investor's Steve Taub reports:

"Luckily, most hedge fund investors don't expect to match or exceed the indexes. Preqin [Note: Preqin is a source of data and intelligence for the alternative assets industry] reported that 47% of fund managers surveyed expect to post gains of only 5% to 6% this year. Preqin also found that two thirds of investors seek annualized returns of 4% to 6% from hedge funds. Just 6% of them are looking for gains exceeding 10%. The London firm says in an earlier report that these findings confirm that just 7% of investors say they invest in hedge funds "as a result of their high returns expectations."

Our firm started using alternative investments to provide protection against an anticipated rise in interest rates in 2014. While that hasn't happened yet, we still believe there is a role for alternative investments in reducing portfolio risk. Alternative investments come in many varieties and we continue to fine tune our use of them to best serve our clients portfolios.

-Keith Jaworski, CFA