GLOBAL RETURN
ASSET MANAGEMENT, LLC

Re: Q1 2014 April 24, 2014

Dear Friends,

[redacted]

I do not expect the next three months to be as impressive. From a **broad market** and **detailed** perspective, concrete data plainly illustrates that valuations are exorbitant; hence, I believe we're in a market bubble. Though the valuation-pendulum often swings much farther, in both directions, than anticipated, I hope 2014 provides an opportunity to purchase securities at lower prices.

Below I provide three examples of how the **sources** and **quality** of corporate earnings have deteriorated. Unfortunately, these low-quality sources of earnings are being used to justify excessive valuations. The bubble we are currently in will continue to expand so long as the market continues to accept these flawed sources of earnings. Following the discussion on the market bubble, I outline what GLOBAL RETURN will be focused on in Q2 2014.

Please feel free to call or email if you would like to discuss anything herein or my current and potential investments.

Respectfully,

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[1] Please see Appendix A for formulas used.
[2] At any given time accounts could have domestic and foreign common or preferred equities, warrants, ETFs, options and cash, so benchmarking is difficult. Therefore, I've provided multiple strategies that are similar to GLOBAL RETURN.

Broad Market Valuations

Where we stand today:

A. Junk Bonds continue to set record level new issuances.
B. Facebook spent $19 billion dollars to purchase a company that had only $20 million in revenue.
C. LinkedIn's stock price has plummeted 28% yet the company still sports a $20 billion market capitalization and did not earn one penny in 2013.
D. In 2013 Gold prices decline 28% and Bitcoin prices soared 5,595%.[3]

There are endless more examples illustrating the ridiculousness occurring in today's market. However, I'll stop here and say, "Something doesn't smell right."

The Shiller CAPE Ratio provides an excellent snapshot of broad market valuations:

	Current	Historical Average	% Above Average
CAPE Ratio	25.21	16.52	53%

Data provided by Robert Shiller.[4]

Shiller's Cyclically Adjusted Price Earnings Ratio (or CAPE) has been elevated above 25 on only three occasions since January 1881. No, that isn't a typo, this data has real depth. Those three occasions began in the years 1928, 1996 and 2003; the rest, as they say, is history.

Digging deeper, from Q1 2013 to Q1 2014 earnings per share increased 5.70%; though from Q4 2013 to Q1 2014 EPS declined 3.50%. Operating margins increased 1.22% year-over-year. Meanwhile, the S&P 500 increased 32.39% in 2013 and 1.45% in Q1 2014.[5]

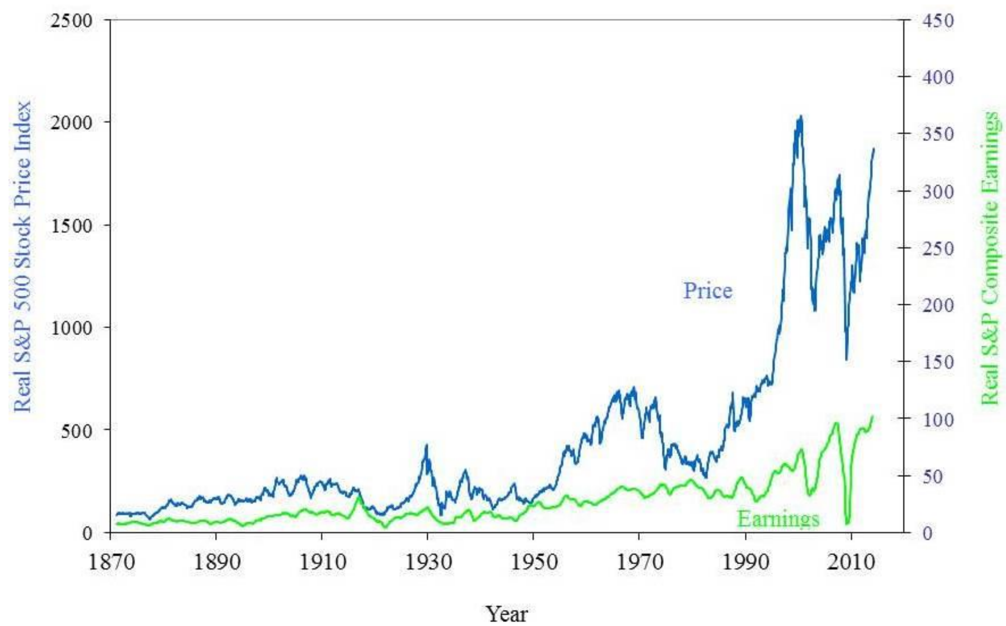
S&P 500	Q1 2013	Q4 2013	Q1 2014 E	QoQ % Change	YoY % Change
Operating Earnings/Share	$26	$28	$27	-3.50%	5.70%
Operating Margins	9.52%	9.76%	9.63%	-1.33%	1.22%
S&P 500 Price	$1,426	$1,848	$1,872	1.29%	31.28%

[3] As an investment vehicle I don't like gold and can't see myself ever owning it. Because gold isn't a productive asset two conclusions transpire: 1) the only way I can make money owning it is if someone else buys it from me at a higher price and 2) valuation is difficult, if not impossible, because the value placed on gold is a psychological attachment gold investors possess. Expounding on #2, it's not possible to construct a discounted cash flow, there isn't a replacement value and gold prices vary from pawn shop to pawn shop and from country to country. Yes, stock prices also fluctuate but there exist a uniform price available to anyone anywhere in the world at any given moment to purchase the same security; this isn't the case for gold because when two transactions occur simultaneously, yet separate from each other, the value placed on the gold will be different in each transaction. If you don't believe me just spend an hour shopping for gold in the Diamond District of New York City, your clothing and how you act will determine the gold's price. The psychological attachment to the value of gold stems from a belief that gold provides either a hedge to other assets or will increase in value allowing the investor to sell for a profit. Consequently, this psychological value is valid until something newer, like Bitcoin, comes along and replaces whatever "value" the gold once had. If you still don't believe my unbelievable claim, then ask yourself if you ever thought stores and restaurants would accept as payment a digital currency that isn't recognized by the Federal Reserve and is "earned" by mining data to solve logarithmic source codes – the unbelievable is in fact happening.

[4] Developed by Noble Prize winner Robert Shiller of Yale University, the Cyclically Adjusted Profit Earnings Ratio (CAPE) most accurately reflects market valuations because previous years' earnings are included in the analysis and, most importantly, the data is adjusted for inflation. Data as of March 2014.

[5] S&P Dow Jones Indices. Dollars rounded.

The year 2008 isn't labeled in the chart below, but you can guess where it would be. Look at where Earnings are for both 2008 and present day; now look at where the S&P 500 Price is for both 2008 and present day.[6]



Opposing Viewpoints

Two opposing viewpoints are required to fully understand security valuations. One viewpoint is from a broad market perspective. The information above on the S&P 500 is an example of this. The opposing viewpoint is on individual details of a security; such-as free cash flow or operating margins. Unfortunately it's difficult to accurately maintain both perspectives over a long period of time ("Don't lose sight of the forest in the trees" versus "Don't lose sight of the trees in the forest.") If maintaining both perspectives was easy, then identifying market bubbles to avoid losses or make money from them would be commonplace.

Because of the inherent difficulty in simultaneously holding two opposing viewpoints it's easy to miss market bubbles. Another factor making bubbles difficult to identify is the fact that they begin, grow, magnify and explode over several years. Watching a market bubble evolve is like trying to watch a child grow taller – we recognize the growth when we stop to think about it, but because we don't notice the change on a daily basis it can be easy to forget it is happening. This is how bubbles in the stock market grow, a little each day. Additionally, because bubbles don't deflate over the course of one week or one month, it's easy for a "buy the dip investment" to become a "what was I thinking loss."

I've experienced two major market bubbles and we're in the third. In mid-1998 I bought my first "flip" house.[7] Other than being legally old enough to sign a contract and having the gumption to undertake the project, I had nothing of value to contribute to this transaction – my parents didn't co-sign the loan,

[6] Data provided by Robert Shiller.
[7] Does anyone even do these anymore? It's when you buy a house, rehab it and then sell it, hopefully for a profit.

I'd never owned a home, I had zero contractor experience, I didn't even know how to calculate a return on investment, yet the bank happily loaned me the money. Whatever underwriting standards, or lack thereof, that were used to loan me – at the age of 18 – $170,000 to undertake this project were the seeds being planted for a real estate market bubble. Though the seeds were being planted, a full four years went by before the real estate bubble began to mature. What happened during those four years?

Technology stocks were introduced to the world. The dot-com bubble actually laid the foundation for the real estate bubble. Scarred from the losses of the dot-com bust, investors turned their backs on "hope and promise" stocks, they wanted fixed assets. Therefore, hundreds of billions of dollars was invested in real estate from California to New York. Over the following five years, from 2003-2008, most people recognized housing prices were vaulting (the individual details of a security), yet few people considered another bubble was percolating (the broad market perspective).

But then we had a hiccup in the markets; two hedge funds at Bear Stearns blew up, they were invested in subprime mortgages. In the following weeks the U.S. stock market actually *rallied* and made new highs within three months. Here, investors were focused on the broad market perspective, "We're near all-time highs! The market shrugged off that isolated Bear Stearns debacle; it must be a strong market." Instead, that was the time to focus on the individual details of each security; Michael Burry and John Paulson had the right idea.

Again, shifting our perspective from broad market fundamentals to one focused on individual details of a security can't be as easy as widely believed. Otherwise, we would never incur losses from bubbles; contrarily we would profit from them.

Sources and Quality of Earnings

With additional clarity on the broad market, I'll now focus on three examples that highlight the "earnings" chicanery being used to inflate stock prices. Unfortunately, U.S. GAAP can be as useless as headline earnings.[8] Consequently, I think it's crucial to look under the proverbial "engine hood" to try and understand the sources and quality of a company's earnings. Of companies that claim to have grown EPS, much of this "growth" is coming from sources that will ultimately become unreliable; hence they are of poor quality.

In the quarterly and annual reports I've read, accounting trickeries range from the obvious Accounts Payable and Receivable extensions, to window dressing Allowance for Doubtful Accounts, to the hard-to-evaluate Goodwill adjustments and Revenue Revaluation of acquired companies.[9]

Proctor & Gamble Company (PG) provides the easiest example of fake-growth to identify. Recently the company extended its payment terms with suppliers. The net effect is that Accounts Payable will *appear* smaller than it actually is, profit margins will "increase" and the company will have more cash, either on its balance sheet or in cash flow. This is a poor source of additional cash flow and increase in operating margins because it has nothing to do with P&G's actual business model; it also lacks quality because

[8] Arthur Anderson certified a lot of tax documents.

[9] After reading a certain company's 10-K I went to their website to view their financials. Amazingly, within 10 days of filing the 10-K, the company posted new financials that were vastly different; no updated filings were provided to the SEC. Most notably, Allowance for Doubtful Accounts decreased by 95%. I took multiple screenshots of the website, which are dated by the website, and continue to monitor the company.

P&G can only do this one or two times. In the future, P&G will have to scramble to identify other sources of “growth” opportunities if they can’t grow organically.

To illustrate P&G’s accounting shuffle, let’s assume I’m a taxi-cab driver in New York City and have a loan on my car. I’m expected to increase my earnings on a quarterly basis, so I refinance my car loan from a 3-year term to a 5-year term. Would you consider my “earnings increase” sustainable and of high quality? Probably not because my rates have to stay within the market; I still have maintenance and depreciation on my car; and gasoline and auto insurance are subject to increasing (those never seem to decrease). Perhaps I’ll have additional cash flow for a short time (P&G will) but I don’t know how I’m going to increase earnings next quarter. In fact, over the long-term the refinance might actually cost me more money because interest rates will be increasing.

Since I picked on LinkedIn (LNKD) in the beginning of this letter, I’ll continue to do so. The company exemplifies why headline and GAAP earnings can at times offer little, if any, assistance in evaluating a company. We don’t have to dig deeply to understand the sources and quality of LinkedIn’s income because, simply put, they don’t actually have any income.

In Q3 2013 the company issued an earnings press release, the first bullet-point was:

- Revenue for the third quarter was $393.0 million, an increase of 56% compared to $252.0 million in the third quarter of 2012.

Here is the first bullet-point for the Q4 2013 earnings release:

- Revenue for the fourth quarter was $447.2 million, an increase of 47% compared to $303.6 million in the fourth quarter of 2012.

The headline earnings look good, right? LinkedIn does of course report GAAP earnings. In Q3 2013 LinkedIn’s net income was a loss of $3.4 million and Q4 2013 net income was a gain of $3.8 million; that equates to $400,000 in income. LinkedIn reported non-GAAP income of $46.8 million in Q3 2013 and $48.2 million in Q4 2013. Now let’s dissect this “income” to better understand its sources and quality.

“*Stock-based compensation*. The company excludes stock-based compensation because it is non-cash in nature and because the company believes that the non-GAAP financial measures excluding this item provide meaningful supplemental information regarding operational performance and liquidity. The company further believes this measure is useful to investors in that it allows for greater transparency to certain line items in its financial statements and facilitates comparisons to competitors' operating results.”[10]

The company’s financial statements state that in Q3 2013 and Q4 2013 LinkedIn had $54,445,000 and $57,177,000, respectively, in stock-based compensation. This compensation removes any net income, whether GAAP or non-GAAP, that LinkedIn reported.

Among investors there exist two contrary opinions on whether or not stock-based compensation is an expense; of course among corporations there exist only one opinion. The way I see it, if stock-based

[10] Q3 2013 Financial Results.

compensation is not an expense to LinkedIn, they should be freely offering it to all of its users.[11] Thank you LinkedIn for the "greater transparency to certain line items..."

I've saved the best for last. Accounting shenanigans are so prevalent in c-suites and quarterly earnings reports that CFOs have actually admitted to it (anonymously of course).

Professors Ilia Dichev and Shiva Rajgopal of Emory University and John Graham and Campbell Harvey of Duke University conducted an exhaustive research study of earnings quality among public companies.[12] What provides persuasive credence to the professors' report is the fact that CFOs from public companies participated in the survey.[13] Several key findings of the research includes:

A) CFOs estimate that about 50% of earning quality is driven by innate factors (where the other 50% is derived from we'll save for another conversation);
B) About 20% of firms manage earnings to misrepresent economic performance, and for such firms 10% of EPS is typically thus managed; and
C) CFOs believe that earnings management is hard to unravel from the outside but suggest numerous red flags that academics can use to identify managed earnings.[14]

If should not surprise any reader that compensation is a main motivation to finessing financial statements and earnings reports. The research report is highly detailed; it covers 80 pages and draws upon other reports to provide additional data and validation to the researchers' findings.

I'm assuming that no CFO proclaimed to misrepresent earnings when in fact he or she did not. Therefore, if 20% of firms admitted to managing earning to misrepresent performance, what percentage of companies *beyond* this 20% are misrepresenting earnings? Further, what percent of companies do *not* believe they are misrepresenting earnings when they report "Net Income" that excludes, as just one example, stock-based compensation?[15] Admittedly, GAAP does offer a more pliable accounting method when compared to the International Financial Reporting Standards. However, based on my experience reading quarterly and annual reports, I wager that far more than 20% of companies engage in earnings misrepresentation. I think this study merely scratches the surface of earnings sources and quality. Finally, if enough people say, "this is the way we conduct our business," over time that method becomes the new standard.[16] I'm perfectly happy being a contrarian as I review financial statements. I'm equally comfortable with my investment returns.

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[11] Additionally, because Earnings per Share is the determinant of corporate earnings and GAAP requires the use of the Treasury Stock Method, it is patently absurd to disregard the impact in-the-money options will have on earnings per share.

[12] Graham and Harvey are also Research Associates with the National Bureau of Economic Research. Graham and Harvey are professors of Finance and Business, respectively, at the Fuqua School of Business, Duke University. Dichev and Rajgopal are Chaired Professors of Accounting at Goizueta Business School, Emory University.

[13] Approximately 10,300 emails were sent to CFOs of public companies. The researchers received 558 responses, a response rate of approximately 5.4%. The email addresses were obtained from *CFO Magazine* and a list maintained by Fuqua School of Business, Duke University. Over 90% of respondents reported at least $100 million in revenue; 36% reported revenues above $1 billion; over 20% reported revenues above $5 billion; and 12% reported revenues of $10 billion or more. Every sector and nearly every industry was represented; the majority of respondents were in manufacturing (30.50%).

[14] Dichev and Graham (2012). Page 1.

[15] As referenced above, I think stock-based compensation is an expense and for a company to not include it in the Net Income is a misrepresentation.

[16] This was the rampant mentality employed during the real estate bubble: "Loan money to anyone anywhere in the country, even if they don't have the required documentation. That's how we do business." This of course became the "new standard" of lending money; we have since been introduced to the "new normal."

Spurious earnings reports are too prevalent in today's market. Some companies have responded by lowering the guidance-benchmark to then only beat guidance so their stock rallies higher. These types of "earnings" go unnoticed in a market marching higher and higher. None of these accounting shenanigans would have passed muster in 2010 and they won't after this bubble deflates.

Q2 Plans

I have four tasks for the second quarter of 2014. First, I'm selling several Value+Catalyst investments that have achieved their relative price targets.[17] Second, I'm updating my Core Value analyses to determine if any positions warrant additional investment; though I'm not optimistic I'll find value at current prices.[18] Third, I continue to scour domestic and foreign markets for investment opportunities. In four months, I've found only two opportunities that warrant an investment, both are Value+Catalyst. Four, I continue to study inflation and the impact it's going to have on corporate operating expenses, income and security prices. To say I'm worried about the negative impact inflation will have is an understatement. Last year the United States government pumped over $1 trillion dollars into the economy; that expensive price tag delivered a 1.9% growth in GDP, which means for every one dollar of input there was only $0.55 cents of output.[19] At some point in the future we'll be paying the price for this.

Conclusion

Over the second quarter cash reserves will continue growing. Admittedly, I'm worried about selling positions to then watch the stocks march higher. Regardless of how overvalued I think our market is, as noted earlier, the value-pendulum swings much farther than often anticipated. Irrespective, I continue to monitor securities on the for-sale list and am a ready seller.

Please contact me if you would like to discuss my portfolio or have any questions related to my strategy or investment philosophy.

Respectfully,

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[17] Value+Catalyst: Securities with misaligned pricing due to short-term challenges or they possess growth drivers that will trigger near-term price appreciation.

[18] Core Value: Securities that will generate long-term price appreciation and compound from dividend reinvestment growth. These securities belong to sectors that will experience significant and profound growth in the coming decades due to global shifts in demographics; an example is the Healthcare sector.

[19] Federal Reserve, U.S. Department of Commerce.

Appendix A

[redacted]

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