GLOBAL RETURN
ASSET MANAGEMENT, LLC

Re: Q2 2014

July 16, 2014

Dear Friends,

As of June 30, 2014 [redacted]

In last quarter's letter I stated that I hope the market provides an opportunity to purchase securities at lower prices. Thus far, this is an unfilled hope. Below I briefly discuss market valuations, inflation and [redacted]

Respectfully,

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[redacted]

Current Valuations

Last quarter I used the Schiller CAPE Ratio to highlight exorbitant valuations. There exist several claims asserting the Schiller CAPE Ratio is flawed. Popular opposition cries that because such large losses occurred during the Tech Bubble and Great Recession then the Earnings per Share data is skewed; effectively, stating “because losses this large don’t normally occur, and won’t occur again, they should not be included in the data.” While it’s factually true that such large losses do not normally occur it’s delusional to pretend they did not occur or will never again occur.

The Schiller CAPE Ratio is one indicator, and like any indicator, it should not be used in isolation. Below I use a more analytical approach to highlight why and how valuations are stretching.

Inflating Valuations

Fiscal stimulus has acted like a boot pumping on an air compressor that’s inflating valuations. It costs our Federal Reserve $0.054 cents to manufacture a one dollar bill; so for the one-time low cost of a nickel, consumers and corporate America have been pumped-up with easy credit terms and a minimal cost-of-capital.

In Q1 2014, Real GDP decreased at an annual rate of 2.9%. In 2013, Real GDP grew by 1.8%, which was down from 2.5% in 2012. Do you see the trend? Simultaneously, throughout 2013 the Federal Reserve pumped over $1 trillion dollars into the economy. Consequently, for every $1 of input only $0.55 cents of output was created.[2] Meanwhile, in Q1 2014 corporate profits declined 9% from Q4 2013; declined 2% when compared to Q1 2013; and are currently below Q1 2012 levels.[3] But stocks aren’t trading at 2012 levels…

When using a discounted cash flow model to estimate the intrinsic value of a company, there are, for the most part, four factors that influence the value: 1) growing cash flow, 2) increasing the expected growth rate, 3) extending the length of the growth period and 4) the market sentiment of these factors. Each factor is an entire topic unto itself. However, I want to point-out the obvious: a company’s cost-of-capital is a significant determinant of its cash flow amount. Hence, by keeping the Fed Funds Rate below 0.25%, the Federal Reserve has dramatically reduced the cost-of-capital, leading to an increase in cash flow and thereby driving valuations.[4] To put this 0.25% rate into context, in July of 2007, just prior to the Great Recession, the Fed’s rate was 5.30%, or 2,020% higher.

Further, headline news screams of “great news” when they report corporations are sitting on record levels of cash. But like any piece of data, we should dig a little deeper. Of U.S. domicile multinationals that distinguish between cash held domestically versus cash held abroad, approximately 60% of cash is held abroad. Generally this cash doesn’t find its way home and isn’t helpful to our economy. Also, headline news seems to forget that much of this cash has a contra-account on the Balance Sheet – it’s

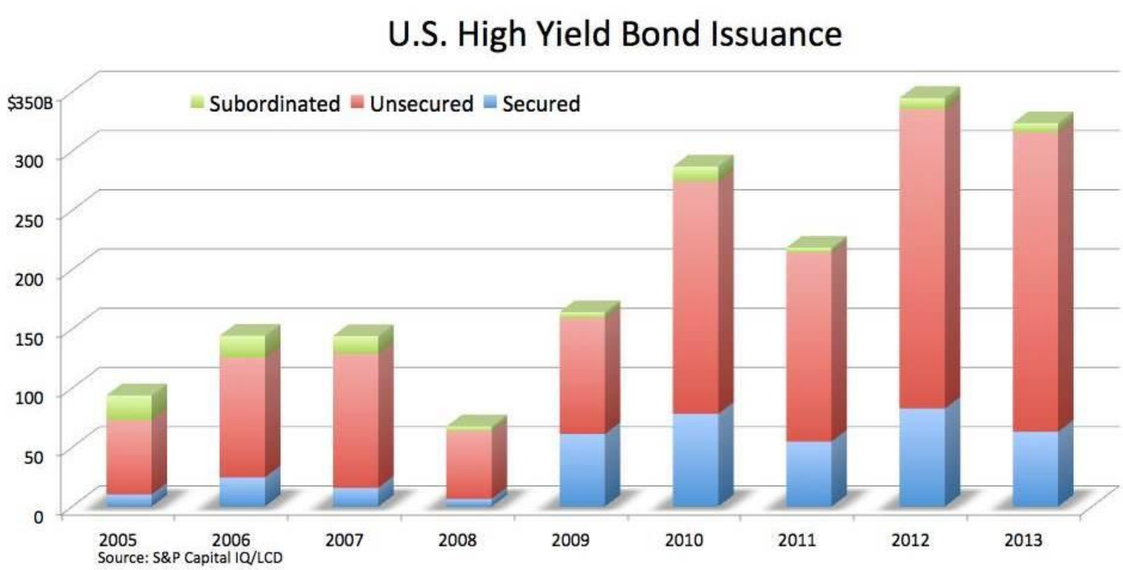
[2] Federal Reserve, U.S. Department of Commerce.
[3] Trading Economics: U.S. Corporate Profits.
[4] In no way am I claiming that growth has not occurred, because it has. I just don’t believe that the means used will justify the end result, which is discussed later.

called Debt and it's a Liability. U.S. corporations now have more than $13 trillion dollars of debt.[5] The level of debt as a function of corporate market values is the highest it's been since 2008.[6] That's a lot of debt considering corporate market values didn't hit their lows until Q1 2009, and yet stock prices are much higher today.

It makes sense corporations would borrow money at these low rates – they're able to increase cash flow, they can lower the required discount rate for projects and perhaps even liberalize their investment standards. But there are several problems here. Corporations haven't invested, that's why they have record-levels of cash; further, they're expected to grow capital spending by a meager 1% in 2014.[7] Plus, interest rates have only one direction to go and that will impact cash flow, which of course impacts valuations.

As for consumers, they too have been tapping into cheap credit. In every quarter of 2013 credit card balances grew on average 5.8%. In Q1 2014, balances increased 6.6% and in March and April balances increased 7.5% and 10.2%, respectively. Guess where these balances show up: corporate Income Statements. Increased credit balances indicate the purchase of goods and services that may not have otherwise been purchased. Unfortunately, when the consumers' low cost-of-capital increases it will be at the expense of their cash flow and corporate profits.

Yes, interest rates had to be lowered to stimulate the economy and yes it has benefited corporations by allowing them to grow out from the depths of the Great Recession. However, unparalleled amounts of debt and a rising cost-of-capital will come at the expense of earnings and refinancing may not be available because, well…there's already been a lot of that. The chart below isn't subjective or existential and this debt will come due. Never mind another credit crisis (we know how to clean-up those messes); I think we're facing inflation like never seen before.



[5] Standard & Poor's Rating Service.

[6] Federal Reserve Statistical Release, June 5, 2014. Includes non-financial corporations only.

[7] Global Corporate Capital Expenditure Survey 2014, Standard & Poor's Ratings Services.

Inflation: The Unintended Consequence

Of course I study Federal Reserve reports and Bureau of Labor statistics.[8] Since 2010, in just 4.5 years, inflation has eroded 9% of each nominal dollar we have.[9] Perhaps that doesn't sound like much given the S&P 500 has delivered a compounded return of 88% in the same period, so let's rephrase this.

Inflation equal to 9% reduces that 88% return by a full 11.81% - for every $1 gained, $0.12 cents needs deducted. Further, Uncle Sam still requires we pay taxes on the 11.81% that we never even got to use.

Let's do the math on a hypothetical investment. Assume we invested $1,000 by purchasing the SPY at the opening price on January 1, 2010 and sold at the closing price on June 30, 2014.

Year	Return	Capital	Inflation	Post-Inflation
2010	14.37%	$1,144	($14.93)	$1,129
2011	1.47%	$1,145	($25.28)	$1,120
2012	15.22%	$1,291	($15.33)	$1,275
2013	31.55%	$1,678	($15.44)	$1,662
2014	6.81%	$1,776	($14.92)	$1,761

Return Excluding Inflation	$879	87.88%
Return Including Inflation	$761	76.07%
Difference	(11.81%)	

Adding insult to injury: 1) I selected years in which the SPY had spectacular returns, and 2) when compared to today, the years selected had a fraction of the dollars circulating in the economy.

At present, inflation is probably the topic that interests me most because it has an extremely powerful and compounding impact on long-term returns, yet it is invisible on financial statements. I surmise it is one of the most influential factors I consider when evaluating a Core Value investment.

Wells Fargo Convertibles and the Golden Age of Banking[10]

I've made two purchases of Wells Fargo Convertible Warrants and have an average cost per warrant just [redacted]

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[8]Government inflation reports are comically detailed. For example, listed on page 9 of the CPI Detailed Report (February 2014) are enough categories of coffee to make Starbucks jealous (eg. roasted, instant dried, instant freeze dried, etc.). Other obscure edibles are listed but I'll leave you to explore them.

[9] Unfortunately, this 9% does not reflect compounding. Bureau of Labor Statistics: Consumer Price Index Detailed Report, Years 2010-Present.

[10] This section is for informational purposes only. GLOBAL RETURN owns Wells Fargo common stock and convertible warrants. Nothing contained herein is or should be construed, or misconstrued, as financial or investment advice or a recommendation to purchase, sell or sell short any securities or derivatives of Wells Fargo or any other security. See additional disclosures on Page 10.

Pertinent terms of the warrants[11]:

a) Exercise Price: $34.01
b) Expiration Date: October 28, 2018
c) Conversion Ratio: 1:1
d) Exercise Price or warrant adjustment[12]
e) There is no Theta

Because I spent the previous three pages outlining my bearishness, you might be wondering why I wouldn't take this profit. The answer is that Wells Fargo is a long-term Core Value holding. Here, long-term means several decades. Banking and credit are two products that consumers and corporations will forever need. Of course these products and how they're delivered will evolve, but I'm banking (pun intended) that they're not going away.[13]

I'm not going to discuss the quantitative analysis I did for Wells Fargo because this type of analysis is generally much easier than qualitative analysis.[14] Ultimately, a little common sense (qualitative analysis) went a long way in deciding to purchase these warrants.

Within the U.S., Wells Fargo is ranked #1 for middle market, small business and auto lending, and commercial and residential loan originations and servicing. The bank ranks #2 for dollars deposited and debit cards issued; is #3 for full-service retail brokerage (based on number of financial advisors) and #4 for wealth management (based on AUM).

Wells Fargo has 9,000 locations around the country through which it acquires clients and sells products. Further, investment relationships are notoriously sticky; thus providing income over the long-term. Amazingly, the bank already works with one-in-every-three households in the U.S. Finally, a bank's profitability grows with economic prosperity and Wells Fargo is clearly in place to capitalize on this.

Another reason I won't sell the warrants, is that there is nearly 4.5 years remaining before the Expiration Date. Plus, I'm not losing money to Theta. The Exercise Price is $34.01 per common share; add in my

[11] For more information, see: Definitive Prospectus Supplement, File Number 333-159736 at www.sec.gov.

[12] Quarterly dividends on the common stock exceeding $0.34/share reduces the Exercise Price, or increases the number of warrants, or fractional warrants, owned, by a pro-rata amount. For more information, see: Definitive Prospectus Supplement, File Number 333-159736 at www.sec.gov.

[13] Every industry is susceptible to innovative and disruptive companies. In banking, shadow and peer-to-peer lending have grown leaps-and-bounds since the Great Recession. There are a plethora reasons why I believe these products do not threaten Wells Fargo but it would be naïve to not continue monitoring them.

[14] The most difficult task for asset managers in evaluating a company is switching between quantitative and qualitative analysis. Quantitative analysis is much easier, anyone can readily access a company's financial statements and there are dozens of online services and Excel documents that quickly compute financial formulas and ratios. Conversely, qualitative analysis is subjective and indefinite, which cannot be bought online or created in Excel documents.

Finally, the quarterly dividend on the common stock currently exceeds $0.34; any amount above this reduces the Exercise Price by an equal amount. If I were to convert the warrants today, my yield-on-cost would be 3.56%, or 33% above the current yield. However, Wells Fargo has a strong history of increasing its dividend; I'm banking (pun intended again) that my yield-on-cost will be well above 3.56% in 4.5 years.

The warrants' run-up in price is evidence they were being avoided at the time I purchased them.[15] Investors feared the banking industry because every day the media was reporting "breaking news" of a new lawsuit or record fine against a bank. This was followed by news of decreased revenue from bond trading. Conversely, at the time of buying the warrants I believed, and still believe, the banking industry has entered a Golden Age of Prosperity. Why would I think such a crazy thought given the "headline news" and the last several years?

The tsunami of the Great Recession wiped-out Lehman Brothers, Bear Stearns, Merrill Lynch, Washington Mutual and many other banks. All of these companies <u>were</u> competitors. Paradoxically, the reconstruction of our financial system has created an oligopoly; and where there are fewer competitors there is more profit.

The greatest obstacle to achieving superior returns is being able to cross the "Bridge of Reason" from the "Land of Crisis" to the "Land of Opportunity". My greatest ally in this investment was the negative sentiment of the mass-opinion (the Land of Crisis), switching from quantitative analysis to qualitative [redacted]

<u>Conclusion</u>

I've already written too much; my enthusiasm must be evident. 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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[15] At their current price, the warrants don't offer a risk/reward ratio sufficient for me to buy them.

Appendix A

[redacted]

Appendix B

[redacted]

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