GLOBAL RETURN
ASSET MANAGEMENT, LLC

Re: Q2 2015 July 22, 2015

Dear Friends,

Net of fees and expenses, GLOBAL RETURN has generated [redacted]

GLOBAL RETURN accomplished this while maintaining, on average, 20% in Cash throughout the year.

[redacted]

Below I discuss corporate debt and profits, followed by an analysis of inflation. I then explain why I love a shell egg company and how luck influences investment results. I conclude with a list of positions and returns. Please contact me if you have any questions or would like to discuss my investment strategy or risk management principles.

Respectfully,

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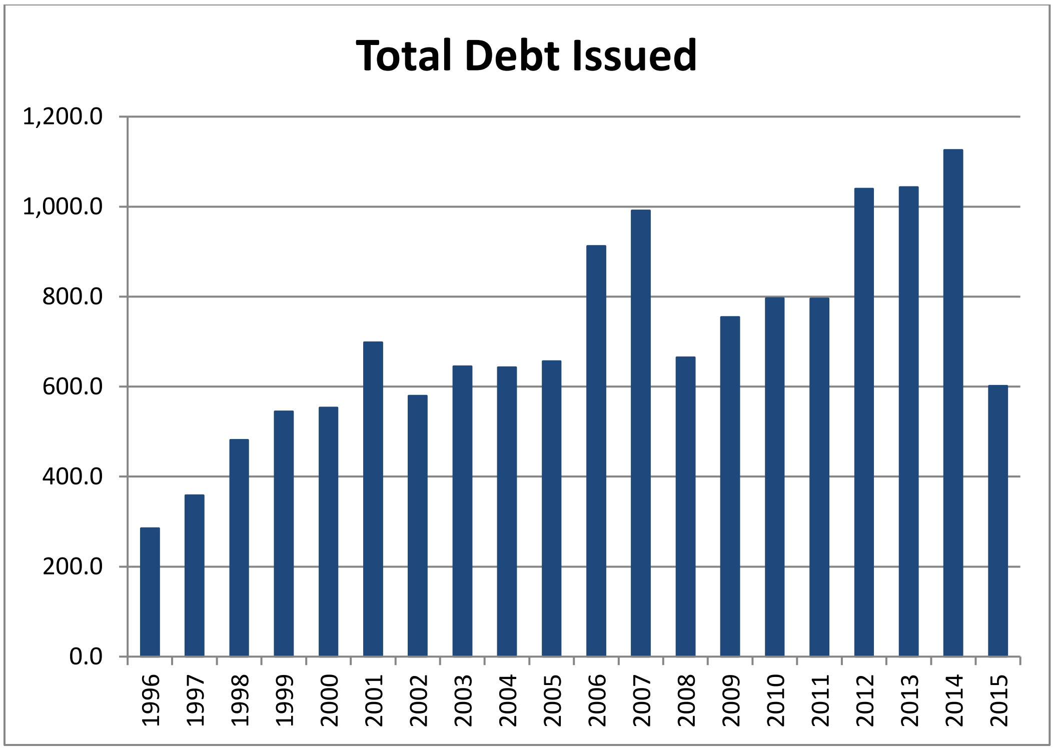
[1] All data as of June 30, 2015. Actual results. Non-levered. Net of management and performance fees and expenses. See Appendix A, Appendix B and Appendix C for additional information and important disclosures. Past performance does not guarantee future performance.
[2] Source: S&P Dow Jones Indices. As of June 30, 2015.

Corporate Debt

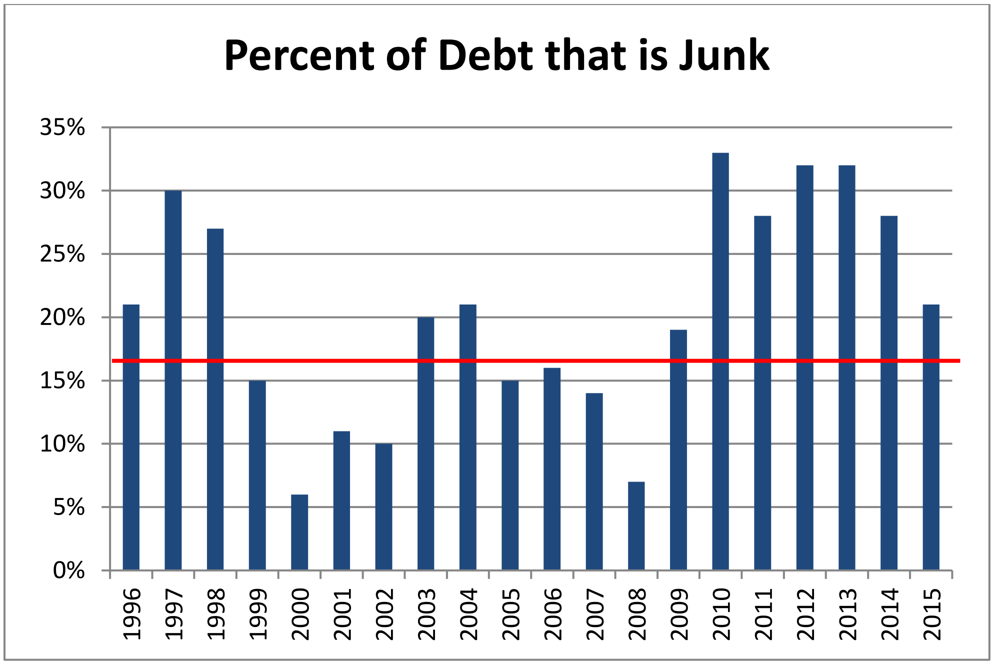
When given a monetary incentive companies will respond accordingly. So how have companies responded to ultra-low interest rates? They've issued bonds.[3]



We all remember the Great Recession of 2008, but it appears we've forgotten what ignited this maelstrom. The Great Recession was ignited when financial institutions issued loans to incapable borrowers. The following chart illustrates our financial system is at it again, albeit this time it's issuing loans to corporations and not home buyers.

[3] Source: Thompson Reuters. Securities Industry and Financial Markets Association. Data as of June 1, 2015.

Junk bonds are being issued at a record-breaking pace.[4]

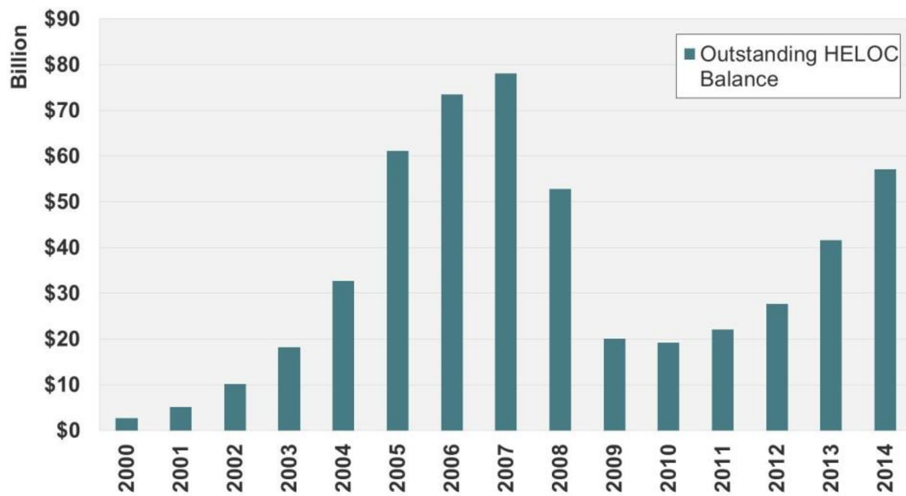


Let's take a brief trip down memory lane. Throughout 1997-1998 a lot of junk debt was ingested by Dotcom-era companies that had no profits to repay this debt. Ultimately, reality surfaced and market tumult followed. The same thing happened again throughout 2006-2008. The one difference here is that debt was issued to individuals who had insufficient income to repay it. Now here we are again, more junk has been issued to more companies and it's been issued for a longer period of time. I surmise the market will again suffer dearly for its lapse of memory.

But corporations aren't the only ones who've responded to ultra-low interest rate incentives.

[4] Source: Thompson Reuters. Securities Industry and Financial Markets Association. Data as of June 1, 2015.

The chart below is from a report issued by Experian and shows the amount of HELOC debt issued to consumers.[5] From 2005-2008, $265 billion in HELOCs were originated most of which were for a 10-year term, meaning they're beginning to reset. By 2016 an estimated 62% of HELCOCs that are resetting and becoming fully amortizing monthly payments, will be on properties with a loan to value ratio greater than 125%.[6] This data must not be a popular topic for the media because none of them are discussing it, but every credit rating agency has issued reports warning about rising defaults and a potential shock from HELOCs resetting.



But U.S. home owners aren't the only ones who are levered. Last week Bill Ackman and Paul Singer both claimed that what's happening in China is worse than what happened in the U.S. in 2008. I'm not surprised conditions in China have deteriorated so rapidly (see my letter dated October 15, 2014).

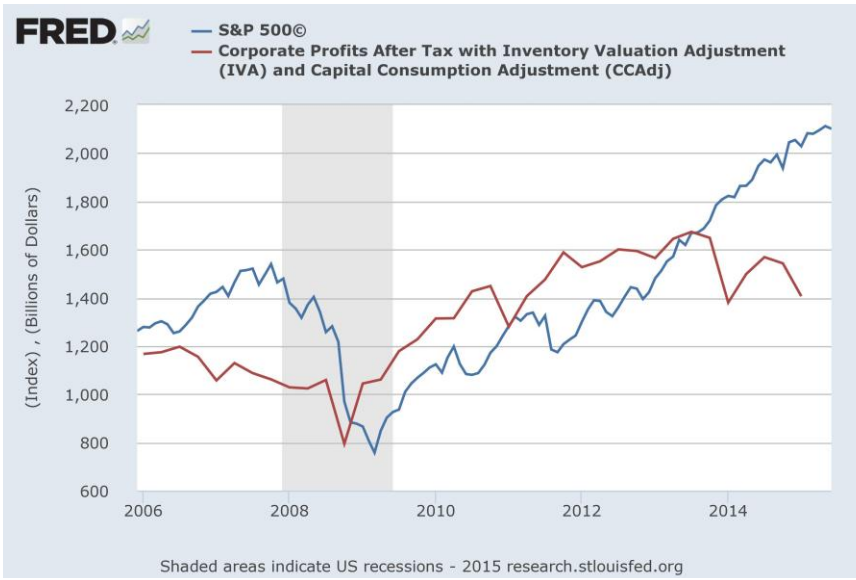
Just like U.S. corporations and homeowners with HELOCs, Chinese investors were given monetary incentives (low interest rates and a government policy allowing real estate to be used as collateral for leveraged stock trading – yes, you read that correctly) and they responded accordingly. Now the fallacy of their "investments" is becoming evident. I posit that what Chinese investors have been doing the last several years with stocks is analogous to what U.S. corporations have been doing with junk debt. Much like Chinese investors, today's debt issuers and investors will be dumbfounded by how much risk actually exists when reality knocks at the door.

I know I sound like a naysayer on debt, but I'm not. I don't think all corporate debt is bad; it's just bad when there aren't sufficient profits to sustain it.

[5] HELOC stands for Home Equity Line of Credit.
[6] Source: RealtyTrac

So How About Those Corporate Profits?

Beyond GAAP reporting, there exist many ways that companies highlight their profits – adjusted, projected, normalized, operating and some methods don't even include taxes or interest (but these are still *real*). I look at these metrics in their minutia if I'm considering investing in a company. However, I also keep an eye on another, mostly unknown, measure of profits.



The chart above illustrates after-tax corporate profits and then makes two adjustments. The first adjustment is for inventory valuations, which removes capital gains or losses resulting from valuing inventory at earlier periods and converts them to current cost basis. Clearly this is a stricter method of valuation and proves to have both positive and negative impacts on corporate profits. The second adjustment is for capital consumption. Capital consumption adjustments convert the value of depreciation used in income taxes to a current cost basis by removing profits and losses that arise from valuing depreciation at earlier periods. Like inventory valuation adjustments, this method is stricter but it removes any finagling that occurs.[7]

The Bureau of Economic Analysis prefers using this measure of profits because it provides *only* corporate profits after-tax from current production, and nothing more or less. The Commerce Department, which has ten ways it measures corporate profits, sites this measure as their "featured number" because it closely aligns corporate profits with changes in GDP. Additionally, because it removes gains and losses from inventory valuation adjustments and capital consumption, it removes industry-specific accounting that doesn't apply across different industries (for example, technology and manufacturing can now both be evaluated based only on their current profits).

[7] Source: Federal Reserve Bank of St. Louis. U.S. Department of Commerce. Economics and Statistics Administration. Bureau of Economic Analysis. Data as of June 1, 2015.

Okay. Now What?

Individually, one risk variable, such as debt, may not invoke substantial market or collateral risk. However, when many risk variables coalesce – such-as debt, rising interest rates, declining U.S. profits, $350 billion Greek bonds in delinquency and a Chinese market meltdown (where a full 70% of stocks have been halted for trading) – they activate an undefinable and immeasurable amount of systematic risk. Here "immeasurable" does not mean "endless" it just means that we don't know how much risk exists in the financial system.

Some investors have questioned why I didn't buy more stock in October's decline and my answer is that the decline wasn't deep enough or long enough to washout the risks I see in our markets. I want to benefit from the market rally but I'm more interested in having cash available to buy securities after the inevitable decline occurs. Participating in the market rally and being prepared with cash is like driving a car with one foot on the gas pedal and the other on the break. I don't know when conditions will change or when I'll need to slam down either pedal but I want to be prepared.

So what am I doing? I'm staying my usual course – identifying securities with appropriate risk/reward opportunities. Occasionally, this process leads to some unexpected luck. Below I discuss our second largest position which has been receiving a lot of news lately and that's lucky for us!

Cal-Maine, Inflation and Luck

My primary purpose is to identify companies that will maximize the utility of every dollar invested. The goal of my primary purpose is to *increase the real purchasing power of my money*.[8]

If in the future the value of my investment has increased, yet I have a lower purchasing power than I possess today, then I have incurred a loss – despite the investment's increase in nominal value. For example, if you adjust today's S&P 500 index price to include inflation, *it's barely above previous highs achieved 15 years ago.*[9] Specifically, assume that 15 years ago a hypothetical investor bought the S&P 500 index and recently sold it so he could use the proceeds to purchase new living room furniture. Though it "appears" his investment has nearly doubled (because the nominal amount has) in actuality he has the same purchasing power he did when he made the investment.[10] Though these figures are approximate, they also don't include taxes and transaction fees. For 15 years, our hypothetical investor assumed a lot of market risk, fees and taxes so that he could breakeven. How's that for investing?!

Below are two hypothetical companies. Other than the factors listed, assume everything between the companies is the same – they sell the same products in the same markets to the same consumers, etc. In 5 years, which company will have better protected my purchasing power, if not increased my return on investment?

[8] Real purchasing power is equal to today's purchasing power plus inflation.
[9] Source: Standard & Poor's. Bureau of Labor Statistics. Robert Shiller.
[10] Perception of data really can alter results…

	Company A	Company B
Stock Price	$20.00	$30.00
Earnings-per-Share	$2.00	$2.00
P/E Ratio	10	15
Net Income	$5,000,000	$5,000,000
Tangible Assets	$80,000,000	$40,000,000
Intangible Assets	$20,000,000	$60,000,000
Total Assets	$100,000,000	$100,000,000
Total Liabilities	$50,000,000	$50,000,000
Total Shareholder Equity	$50,000,000	$50,000,000

As an investor, I'm buying stock in a company for its future earnings potential and I want to do this at the least expensive price available. Therefore, Company B, even with a share price and P/E Ratio 50% higher, is the better investment.[11] Here's why.

Company A requires *double the dollars* needed for maintenance capital expense than Company B, which drastically reduces the cash available to enrich shareholders and the company. Further, inflation doesn't have a line-item in financial statements, so whatever the maintenance capital expense is, you'll have to add to it 3% compounding every year.

During the next five years while Company A is spending a higher percentage of its Revenue than Company B on maintenance capital expenses (just to retain its market share), Company B will be redeploying the difference into income-generating investments for the benefit of shareholders and the company. Company B could pay a higher dividend, buyback shares, acquire competitors, invest in research and development, invest in customer acquisitions, inventory management, etc... Reinvested earnings and the value of a company are intrinsically connected, which is why my primary purpose is selecting companies that will maximize the utility of every dollar invested.

So contrary to popular opinion that a cheaper stock price and lower P/E Ratio offer better investment prospects, there are occasions when the reverse makes infinitely more sense. In a rising market, like the one we've lazily enjoyed, Company A could generate a nice return on investment, but this isn't the kind of market that will easily pull investments higher.

Getting Lucky

With this understanding, Cal-Maine is like Company B, which is exactly why I bought the stock. But then I got really lucky, twice. I wish I could say I increased the position knowing it would soon vault higher but I didn't, I simply got lucky.

[11] This is a great example of how perception of data can influence an investor's decisions. A company with a lower stock price and P/E Ratio may appear to be the better investment yet actually deliver lower returns over the long-term. Additionally, having more tangible "assets" may prove to be a liability to long-term prospects.

No one could've predicted that the U.S. would experience the largest outbreak of avian flu in history, that egg supplies would evaporate and that Cal-Maine (already the largest egg distributed in the country) would be spared from infection. So when retailers needed eggs to stock their shelves, Cal-Maine was able to deliver; and due to demand-supply constraints, egg prices more than doubled. But my luck didn't stop there.

Cal-Maine and many companies in the poultry industry were heavily shorted when the outbreak began. As avian flu spread, egg prices skyrocketed to levels not seen before and Cal-Maine was the dominant supplier in a hugely demanding market. This prompted many short sellers to deliver me a second dose of luck, they covered. There's nothing profitable or comfortable about being short a stock that rises over 70% in a few months, which is what happened with Cal-Maine.[12]

Why would I admit this luck? Shouldn't I be bragging that I'm always looking for companies like Cal-Maine and that this is the mere result of my investment prowess? The answer to this question is "No."

Investment success, especially when it happens quickly, can dilute judgement with equal speed. I don't want to go to work next week with an eroded sense of humility; this would lead to inevitable losses. My investment in Cal-Maine was the beneficiary of, literally, a black swan event (pun intended). By stating I got lucky on my highest conviction investment removes the potential for an inflated sense of self.

Additionally, over the last several months I've been studying my performance and have come to realize that luck (both good and bad) influences my returns. It's crucial I recognize how my skill and luck intersect to produce my returns; understanding this will allow me to better identify high-probability investments and behaviors.

But how am I supposed to apply my skill set and dance under the raindrops of luck? As luck would have it (another pun), I was asking myself this question when I stumbled into Michael Mauboussin's book, "The Success Equation: Untangling Skill and Luck in Business, Sports, and Investing."[13] (Mauboussin is Head of Global Financial Strategies at Credit Suisse. He also studies and lectures on, among many other topics, investment skill and luck.)

Irrespective of when I buy or sell a stock, the market will go up and down, sometimes quickly and sometimes slowly. Obviously, my investment returns are directly related to security price fluctuations but unfortunately I don't know when or by how much these fluctuations will occur, it's just luck. But no long-term career on Wall Street is cemented with one dose of luck, skill is required.

As we've just reviewed though, investment returns aren't 100% based on skill; otherwise Wall Street would never lose money. There is sufficient intellect and technology to forecast anything someone can fathom about a company, yet two people (like in the case of Cal-Maine) place capital on opposite sides of an investment and only one person wins. Hence it's the combination of luck and skill that produce investment results; and surprisingly, we have some control over the influence luck has on our returns.

[12] Here's my lawyer's contribution to this letter: I'm not recommending the purchase or sale of Cal-Maine.
[13] Harvard Business Review Press, 2012.

Mauboussin asserts that when luck influences an outcome (like in investing), skill is best defined as a process for making decisions.[14] Why this is a great definition for skill should be obvious – luck by its very nature is unpredictable (loosely speaking, as we'll see shortly) and a process for making decisions is predictable. Therefore, to judge the quality of an outcome, a checklist process for making decisions is required because the only observable data input that is constant is the checklist process.

Further, because the process for making decisions is constant (whereas, luck evolves with market variables), outcomes can be evaluated as to whether or not they are the result of the process for making decisions. Once a process for making decisions is determined to be a causal factor for the outcome, improvements to the process can occur. Therefore, skill is introduced at the point in which a process for making decisions is improved to better the outcome being evaluated.

Relying on a checklist process to make investment decisions is crucial; though I only discuss two, there are many reasons I use on them. First, my goal is to generate superior risk-adjusted returns. If I can identify investment characteristics and behaviors that, over a long period of time, will generate superior returns, then obviously I should construct, utilize and amend a checklist process to identify high-probability investments and behaviors. I don't want to recreate the wheel every day I come to work; and frankly, a checklist process makes my work easier. Second, the market can be chaotic and this chaos will consciously or unconsciously influence our emotions. Unfortunately our emotions will distort our perception of reality and we'll make decisions based on these emotions. If however we have a well-developed checklist process, we will have for ourselves instructions on how to manage our investments.

Controlling the Influence of Luck in Returns

Earlier I stated that we do have some control over the influence luck has on investment returns. Ideally, skill (more than luck) has a greater impact on my returns because skill can be evaluated and improved. So how do I control the influence luck has on my returns? While analyzing my performance, a pattern of behavior emerged that may answer this question.

Since January 2014, I've maintained, on average, 14% of assets in Cash; and over a period of 13 months I evaluated 150 companies and *didn't make any new purchase*s. Sitting with this much Cash for a long period of time requires a phenomenal amount patience and persistence, especially in today's fast-moving-make-a-buck-and-move-on world in which we live. Maintaining patience and persistence is a skill few have. Luckily (pun intended), I have these skills and they enabled me to stumbled into Cal-Maine – my first new purchase in 13 months.

[14] Mauboussin, Michael. *The Success Equation: Untangling Skill and Luck in Business, Sports, and Investing.* Boston, MA: Harvard Business Review Press, 2012. Page 19.

Mauboussin states, "…the very effort that leads to luck is a skill."[15] Without patience I may not have had enough Cash to buy Cal-Maine; without persistence I may not have evaluated the previous 149 opportunities that led me to Cal-Maine; and without my checklist process I may not have identified Cal-Maine as a low risk/high reward opportunity.[16] So luck does play a role in investing and to some degree we have control over how much it influences our results.

All that said, I'll continue exercising patience and persistence as I run investment opportunities through my checklist process and I'll place capital when I think the risk/reward ratio is significantly in my favor. But remember, if anything like what happened with Cal-Maine happens again, it will be just luck!

Conclusion

As stock prices decline, my list of potential investments will grow longer, my cash balance will decline and the sentiment of my letters will change to bullishness. I yearn for declining prices because this is when cash is most productive – I can buy more stock with less money. It should not be ironic that declining prices offer reduced risk and increased returns, which, after all, is what every investor wants.

Please contact me if you would like to discuss my investment strategy or risk management principles.

Respectfully,

Elliot Trexler

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[15] Mauboussin, Michael. *The Success Equation: Untangling Skill and Luck in Business, Sports, and Investing.* Boston, MA: Harvard Business Review Press, 2012. Page 17.
[16] I am not recommending the purchase or sale of Cal-Maine.

Appendix A

[redacted]

PAST PERFORMANCE DOES NOT GUARANTEE FUTURE PERFORMANCE

[17] All data as of June 30, 2015. Actual results. Non-levered. Net of management and performance fees, which are 1.5% of assets under management and 15% of profits, respectively, and expenses. See Appendix C for additional information and important disclosures.
[18] Compounded Annual Growth Rate.
[19] Inception to date return.

[redacted]

Appendix C

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