GLOBAL RETURN
ASSET MANAGEMENT, LLC

Re: 2014 Full Year January 15, 2015

Dear Friends,

As of December 31, 2014 GLOBAL RETURN, for the second year in a row, beat every major index and [redacted]

Year-to-date, we have had exceptional performance, especially when considering returns are unlevered and we ended Q3 with nearly 17% in Cash. Importantly, I have also maintained, on average, over 9% in Cash throughout the entire year. Maintaining cash and no leverage provides a margin of safety and the flexibility to capitalize on opportunities as they arise. While I may have slightly lagged the top performing benchmark during this quarter, these combined benefits far exceed the six-tenths of one percent difference and will outpace any benchmark in the long run.

Below I discuss valuations, how perception alters our understanding of data and the use of cash and leverage in an investment strategy. Please contact me if you have any questions or would like to discuss my investment strategy or philosophy.

Respectfully,

Elliot Trexler
etrexler@globalreturnam.com
(917) 633-4195

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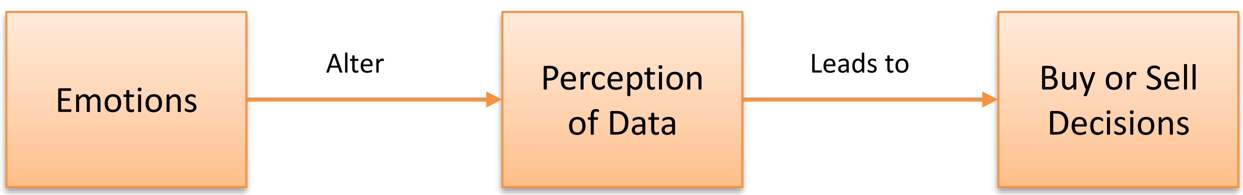
[1] Actual results. Non-levered. Net of management fee and expenses. See Appendix A and Appendix B for additional information.
[2] I have added an additional index that reasonably represents my peer group. A full description is included in Appendix C.

Current Valuations

Security valuation is subjective. We know this because security prices fluctuate based on the equilibrium of buyers and sellers who deem a security as either valuable or risky given its current price. For example, in the late 1990's some investors were buying Coca-Cola stock at 40 times earnings; that decision was based on their perception of its intrinsic value. Today Coke can be bought at 20 times earnings.[3]

Scientific data has proven that our emotions directly influence the decisions we make. Specifically, our emotions alter our perception of data and we make decisions based on this perception. With investing, we develop a perception of a security's intrinsic value and then decide whether to buy or sell it. Herein lies the greatest challenge investors face – minimizing the influence emotions have on developing a perception of intrinsic value, which will determine our buy and sell decisions.



With this understanding, let's look at the data.

The S&P 500 has hit new highs 37 times this year; that's once per week every week of the year. Simultaneously, the Nasdaq has hit new highs 32 times this year, just under once per week every week of the year. As these indices were hitting new highs, so too were my account values. However, I wasn't celebrating these new highs. Instead, I began researching the S&P 500 and Nasdaq components looking for data to validate that these indices were as strong as they appeared. After reviewing a plethora of data, I've developed the perception that the market is much weaker than warranted by the plentiful highs of 2014.

First, the S&P 500 and Nasdaq are capitalization-weighted, so the largest stocks influence the indices' price more than the smallest stocks. At the end of Q3, 26% of the S&P 500 stocks were actually down, on average, over 9%.[4] In the Nasdaq, 52% of stocks were down 20% or more from their yearly highs (which is technically bear market territory).[5]

Secondly, when you adjust the S&P 500 to include inflation, which is an expense that has been incurred, the value of the S&P 500 is *still below* the all-time high achieved in 2007. In other words, if seven years ago an investor took his S&P 500 profits and went shopping, he would have been able to buy more goods and services than he could buy today. Simply put, the perception that the S&P 500 is more valuable today than in previous years is wrong.

[3] If the buyers who paid 40 times earnings held the stock, they might just now be breaking even some 15 years later.
[4] S&P Dow Jones Indices.
[5] Bloomberg Markets.

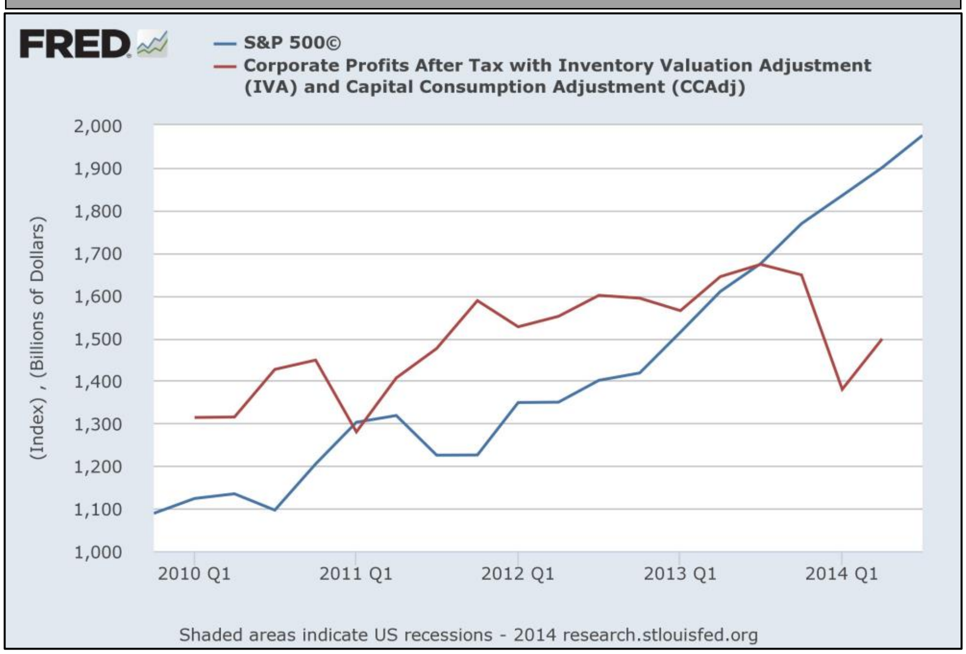
Finally, most people claim the S&P 500 is "fairly priced" and quote its Forward Price-Earnings Ratio of 14.59 as evidence to support this perception. Conversely, my own analysis leads me to the opposite perception – our markets are overvalued.

The S&P Dow Jones Indices offers a lot of valuable data. However, as recently as October 3, 2014, they reported that the S&P 500 is trading at the 2015 year-end P/E Ratio of 14.59 (using the September 30th closing price of 1972.29); this is a delusional perception.

In order for the S&P 500 to be worth a Forward P/E Ratio of 14.59, it will have to earn $134.89 earnings per share; that's a 25% increase over the next five quarters. In June, analysts guesstimated earnings would grow 9% in Q3 2014. Already those analysts have downgraded their earnings growth to 4.6% - that's a 49% reduction in EPS and I suspect more is on the way.

The figure below charts the S&P 500 price with Corporate Profits; it's similar to the P/E Ratio for the S&P 500. Q2 Corporate Profits data hasn't been charted yet, but imagine it is just over 1,600. When I look at this chart I think of the investors who bought Coca-Cola stock at 40 times earnings some fifteen years ago. These are the same investors who thought stocks were "risky" in 2010 and are today saying, "Stocks are fairly valued."

Figure 1: S&P 500 Price and Corporate Profits After Tax



Global Markets

Across the pond in Europe, things are getting worse. In Q4 2013 and Q1 and Q2 2014, GDP growth rates were 0.3%, 0.2% and 0.0%, respectively. Economic contraction and fears of another recession have led the European Central Bank (ECB) to announce a set of initiatives to stimulate growth. Specifically, the ECB lowered the deposit rate to -0.20% (that's not a typo) and the refinancing rate to 0.50%. Additionally, the ECB will purchase $700 billion to $1 trillion worth of covered bank bonds and other asset backed securities. The ECB's goal is to put more cash into the financial system, encourage banks to lend and increase inflation, thus inflating prices. For investors who missed the Fed-led U.S. bull market, maybe there's a second chance with Euro stocks. I have a few prospects myself.

Last month, China's central bank injected over $81 billion dollars into the country's top five banks. The Chinese central bank provided this liquidity amid data indicating that the economy (which is the second biggest in the world) is faltering. There was a time when this negative data was noteworthy or the markets would decline. However, Alibaba, a company headquartered in China, went public in what turned out to be the largest initial public offering in history. Simultaneously, the S&P 500 went on to make new highs.

This reminds me of when two hedge funds at Bear Stearns collapsed after their subprime mortgage bets soured, yet the S&P 500 marched on and made new highs within three months. I wonder what the perception was of the investors who were buying stocks at that time.

Leverage and Cash

I'm a value investor who likes cash and doesn't use leverage. Maintaining cash and not using leverage will occasionally "appear" to limit my returns; however, this perception will be proven wrong over time.

Risk management is about controlling what can be controlled and limiting exposure to the things that cannot be controlled. *The most significant element of investing that I want to and can control is the price at which I enter and exit an investment – leverage and cash directly impact this*.

On Leverage

1. I have no control over stock price movements, so if a levered position goes against me, I surrender control of my exit price because the lender can call his leverage and force me to sell. I won't put myself in a situation where I can't control my exit price.
2. Using leverage allows an investor to pay much higher prices for securities, which thus have smaller returns, because the leverage will increase his return on equity. This of course erodes buying discipline, "it worked last time so it will probably work this time".

On Cash

1. If I have cash on hand, as security prices decline I'll be able to purchase more securities with less money and improve my entry price. "Cash is King" is one of the more prevalent lies told when the market is declining; it's precisely at these times that we should be spending cash to buy securities.[6] "Cash is King" only when the market is overvalued; whoever has cash probably sold his shares to the "market is fairly valued" buyers and is waiting for price declines.
2. Using cash to purchase securities requires me to be extremely selective with the securities I buy and sell because there is always a limited amount of cash. This selectivity ensures greater prudence and discipline, which leads to higher returns.

Conclusion

As bearish as I may seem, I am finding opportunities. I entered a new position three weeks ago and the company has quickly become one of my favorite holdings. This is the first new position I've established in 22 months. Why have I waited so long to establish any new positions? Benjamin Graham said it best, "Observation over many years has taught us that chief losses to investors come from the purchase of low-quality securities at times of favorable business conditions."[7] We have been in favorable business conditions for several years and buying second-class securities is going to become very costly over the next several quarters.

As stock prices decline, my list of potential investments will grow longer and the sentiment of my letters will change to bullishness. I yearn for declining share prices because that's when my cash is most productive – I'm able to 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 philosophy.

Respectfully,

Elliot Trexler
etrexler@globalreturnam.com
(917) 633-4195

[6] Assuming nothing has fundamentally changed (i.e. Enron).
[7] *The Intelligent Investor*. Page 516.

Appendix A

Portfolio Composition	
Domestic stocks	73%
Foreign stocks	6%
Other*	4%
Cash	17%

*Includes preferred stock, convertible warrants and ETFs.
Percentages are rounded.

Appendix B

[redacted]

PAST PERFORMANCE DOES NOT GUARANTEE FUTURE PERFORMANCE

[redacted]

Appendix C

[redacted]

[redacted]

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