GLOBAL RETURN
ASSET MANAGEMENT, LLC

Re: 2013 Year in Review February 18, 2014

Dear Friends,

After five years of investing in publicly-traded securities, I've decided to make my strategy available to outside investors by creating Global Return Asset Management, LLC.

My cumulative returns for 2013 are 22.6%[1]. For most of the year I maintained a cash balance between 1% and 8%. The strategy employed to generate these returns is the same strategy I'm making available to outside investors. Approximately 84% of my liquid net worth is invested in this strategy.

Investment Strategy & Philosophy

I invest in companies that I understand, that are shareholder friendly, have strong financial statements, high returns on capital invested and provide me a margin of safety. Most of the time I'll gain exposure to these companies via cash equities; however, from time-to-time I'll purchase other types of securities to access a desired return characteristic. For example, I wanted fixed income in the portfolio so that I could generate cash to purchase additional securities. However, I loathe bonds, primarily because they currently offer a *negative* real rate of return.[2]

I'm going to digress here, but the time won't be wasted because I'm going to further elucidate my investment philosophy and why I prefer stocks over bonds. Many, if not most, financial advisors have sold their clients bonds. The advisors' reasons appear to make sense – they claim they're "secure" investments and that they offer a fixed payment. Here's why those reasons don't make sense: [3]

If secure means, "Should the company go bankrupt, the bondholder gets paid first," then I question the advisor's prudence. Why would I ever invest in a company if there's even a *possibility* of it going bankrupt? Further, let's assume investors want their bonds to be investment-grade. Wells Fargo, Coca-Cola, Johnson & Jonson, and many other investment grade companies like them, offer common stock that pay dividends that yield much more than their bonds (in some cases 400% or more). If investors want to own investment-grade securities, does it make sense to settle for a smaller payment? Finally, if the dividend payment is in question then the entire company should be avoided.

Perhaps secure means, "less volatile." There are as many opinions on volatility as there are stocks listed on the New York Stock Exchange; so I've attended several seminars at the Volatility Institute at NYU Stern School of Business to develop my own concept. I've settled on an analogy that helps me

[1] Net of 1.5% Management Fee. **PAST PERFORMANCE DOES NOT GUARANTEE FUTURE PERFORMANCE.**
[2] I've been saying this for years and can appreciate I don't have the clout of today's luminaries so I'll just quote the man himself. Says Warren Buffett, "Bonds, they're terrible investments now. That will change at some point... people could lose a lot of money if they're in long-term bonds." Interview with CNBC on May 6, 2013. In another article authored by Buffett, when referring to bonds he stated, "In truth they are among the most dangerous of assets." Fortune Magazine, February 9, 2012.
[3] I understand there are instances in which individuals and institutions must own bonds because of a directive or regulatory reasons. My commentary is directed to the owner of bonds who believes that bonds will either a) earn a return on investment or b) provide some sort of "security."

understand it – "Volatility is like a loaded weapon, it can be fun and entertaining yet completely destructive."

Two simple methods can defend a portfolio from the destruction volatility has to offer: 1) limit, or completely remove, leverage, and 2) limit exposure to securities that exhibit high-levels of volatility.[4] But let's not forget that a portfolio requires volatility to generate a return. The crucial task is finding a level of volatility for each investment that creates an acceptable risk/reward ratio (assuming volatility is the 'risk' portion of the ratio) and then confirming this ratio matches the investment mandate.

Recognizing that every investment must have volatility to generate a return and an appropriate risk/reward ratio, then using volatility as a measure of risk suddenly makes bonds appear *extremely risky.* Using our loaded weapon analogy again, a bond offers a double-barreled problem, prices move up-and-down (i.e. they are volatile) and yet the bond generates a *negative* real rate of return on the fixed payments (the 'reward' part of the ratio). In essence, the investor gets all the risk and no reward.

As for the fixed payments that bonds offer, the marketing-headline "Coupon Rate" and "Yield to Maturity" are, unfortunately, often misunderstood. The prevailing belief is "the coupon rate is what my return on investment will be if I buy this bond." But I have to ask, when was the last time you were able to purchase a bond at par value? It seldom happens. So we must then look at the Yield to Maturity. In order to achieve this yield the coupon payments *must be reinvested at the same rate* as the bond's current yield and the bond *must be* held to maturity. Regrettably, because of "quarterly rebalancing" it's unlikely the investor will hold these bonds until maturity.

The end result is that the investor is buying a bond for a low fixed rate (presently a real capital-eroding rate) because that bond is supposedly more secure than owning the company's stock. I posit if an investor shouldn't own the stock, then they probably shouldn't own the bond.

Digression aside, I wanted fixed income in the portfolio. I don't like bonds and I wanted a large margin of safety, so I bought two preferred stock ETFs. Several risks exist in purchasing these securities, the most significant being credit quality, callability and par value of each preferred as a function of the purchase price of the ETF. Evaluating the credit and callability of the preferreds was the easy part. The challenge was matching the ETF's yield with the par value of the callable preferreds and the time in which they could be called. For example, it would have been highly risky (and more likely assured losses) if I bought the ETFs for $50 per share with a 5% yield and 75% of the preferreds could be called in one year at their par value of $25.[5]

However, the two ETFs I bought had a minimal number of preferreds that could be called in the next three years. These three years are important because both ETFs cost over $25 when I bought them, but when I bought them their yields were 7.5% and 6.6%, which more than compensates for the potential price decline that could occur should several preferreds be called and replaced with lower-yielding preferreds. Further, all of the payments I've received have been, and will continue to be, reinvested to purchase more shares of the ETFs. Thanks to dividend reinvestment, my yield on cost for the two ETFs has increased to 7.75% and 6.77%; additionally, my share ownership has *increased* by 2.9% and 2.3%.

[4] Unfortunately, as we saw in the credit crisis of 2008-2009, securities that appeared to have *minimal* volatility (e.g. homes) were actually quite volatile; hence the value of limited, or no, leverage.
[5] $25 is, for the most part, the par value of preferreds.

Finally, between the two ETFs I have exposure to 447 different companies. I know of no bond, or bond ETF, that offers characteristics that could rival these two ETFs.

Continuing with my investment philosophy, I would like to briefly discuss "margin of safety." Generally, a margin of safety can be classified as either a quantitative or qualitative attribute of a company. These attributes manifest in many different forms and can grow more durable in great companies (to the benefit of investors) or weaken in lousy companies (to the detriment of the company and its investors).

For example, let's assume a company has a book value of $20 per share yet is available for purchase at $10 per share. From a purely *quantitative* perspective, this is a strong buy. Fast forward three years, this same company has a book value of $20 per share yet the cost per share is $40 – it could still be a strong buy. What would make this a strong buy at a price double the book value? The company has superior *qualitative* features. An example of a superior qualitative feature would be an elite product (e.g. Apple's iPhone) or business model (e.g. Starbucks does sell coffee but its *business model* is to create "the place" between home and work that offers a continuity of experience around the world; the local pub doesn't offer this and this model is different from fast-food restaurants because they aren't designed, nor do they want, to have people lounging for hours).

Netflix's Price/Earnings Ratio is an example of a quantitative attribute, and its fluctuation provides an example on how a margin of safety can grow more durable or weaken. [6]

In 2011, total earnings per share was $4.17 and at the end of the year the stock price was $69.30, this equates to a P/E Ratio of 16.61. On January 22, 2014 (after the market closed), the stock reported quarterly earnings of $0.79 per share, making its trailing twelve month EPS $1.85. The day after this earnings report the stock closed at $386.53 per share, equating to a P/E Ratio of 208.93.

Netflix	**2011**	**January 22, 2014**
Price	$69.30	$386.53
Earnings per Share	$4.17	$1.58
P/E Ratio	16.61	208.93

Earnings per Share is for the trailing twelve months.

The price per share – a quantitative feature – has removed any margin of safety. Further, by my estimation, no qualitative feature can defend the P/E Ratio significantly enough to ensure a margin of safety exists at this ratio and price per share. Yes, membership and content have grown and projections indicate earnings might grow but why would I buy a stock for $386.53 for the pleasure of receiving just $1.85 in earnings when no margin of safety (quantitative or qualitative) exists?

In summation, I endeavor to invest in companies in which I know what the margin of safety is and can identify when it's growing stronger or weaker.

[6] I have not owned or sold short Netflix stock or derivatives in the past twelve months. The use of Netflix stock is purely for illustrative purposes and is not a recommendation to buy, sell or sell short the stock or its derivatives.

Conclusion

Hopefully by next quarter I'll have hired an analyst, I've already interviewed several. Additionally, I hope to have the website fully functioning in the next few months. Please contact me if you would like to discuss my portfolio or have any questions related to my strategy or investment philosophy.

Finally, if you're in New York City on May 8th and would like to attend an investment symposium I and several cohorts are hosting please let me know. Confirmed speakers include Howard Marks (founder of $83 billion Oaktree Capital Management), Paul Hilal (partner at $13 billion Pershing Square Capital Management) and Whitney Tilson (founder of Kase Capital Management and the Value Investing Congress) among many other successful investors.

Respectfully,

Elliot Trexler

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