The Great Rotation is underway!

The Great Rotation is a phrase that market pundits have coined to describe the current shift from fixed income to equities by investors who now believe that stocks are set to provide strong returns. Not surprisingly, this move is being encouraged by investment commentators just as market indices reach new highs. They argue that now is the time to increase the allocation to equities because:

- ✓ **interest rates are low and stocks provide better yields**
- ✓ **corporate profits are increasing**
- ✓ **the U.S. economy, led by a resurgent housing market is rebounding**
- ✓ **American politicians are beginning to compromise on key legislation**
- ✓ **Europe is starting to solve its economic and debt problems**
- ✓ **emerging markets are poised to reaccelerate their growth**
- ✓ **the corporate acquisition market is starting to percolate**

It appears that investors are buying into these arguments. After several years of sitting on the sidelines investors poured more than fifteen billion dollars into equity funds in January. These purchases represent the largest monthly flow into equities since 2004; ending almost two consecutive years of monthly outflows. Should this trend continue, equity markets will continue to rise due to increased demand. As has happened so often in the past, rising prices beget higher prices in the short and medium term. And as has happened in the past, investors rotating into equities at market highs will lose money in the long term.

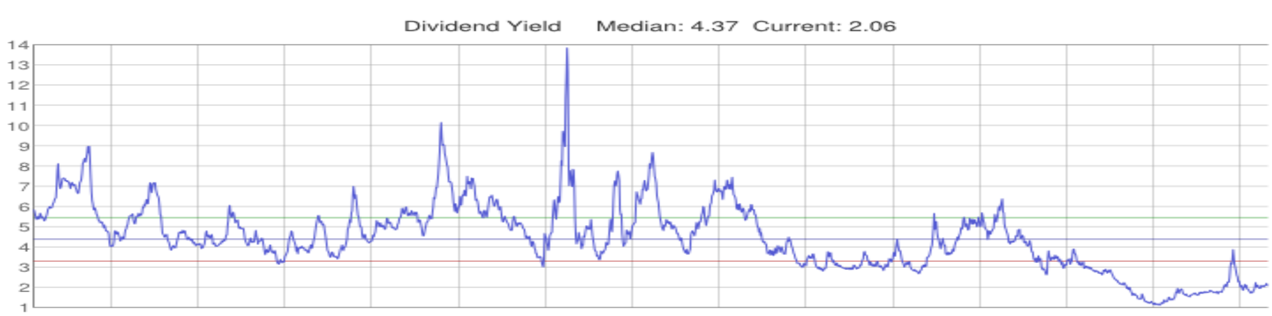
While all of the positives mentioned above are currently true the proponents of a move into equities ignore today's elevated market valuations and the associated risk that accompanies such valuations. It cannot be stressed enough; the most important determinant of long term returns is the asset's valuation at its purchase price. At current levels equity markets appear expensive by historical standards as the three graphs below indicate.

Graph 1[1]

Schiller P/E Ratio 1880 - Present

Graph 2[2]

S& P 500 Dividend Yield 1880 - Present



[1] www.vectorgrader.com

[2] www.vectorgrader.com

Graph 3[3]

Market Cap to GDP Ratio 1850 - Present

Optimistic market observers argue that today's very low interest rates justify current equity prices. We believe that it is only a question of when, and not if, interest rates rise. When interest rates eventually do go up share prices will fall. It has been our experience that long term returns are likely to be modest and the risks high when valuations reach the current levels as indicated in the foregoing charts.

In addition to the aforementioned valuation concerns, other issues give us reason to be cautious:

- ✓ **while global growth is improving it is still far below the long term average**
- ✓ **unemployment levels in developed countries continue to be high**
- ✓ **corporate profits are at unsustainably high levels and will eventually revert to their mean**

[3] www.vectorgrader.com

- ✓ **optimism amongst retail investors and financial industry professionals is near record levels; this bullishness is a very strong contra indicator**
- ✓ **global stock markets have had a very strong run over the past two years and are due for a correction**

If the Great Rotation continues and the prices of our investments move to their intrinsic values we will Rotate the Other Way! We will sell investments that reach our target prices and purchase short term government treasury bills with the proceeds.

The prospect of realizing profits, as investors flock back into the markets, provides us with the opportunity to explain to you our discipline for selling securities. Interestingly, this very important step in the investment process is rarely discussed. We strongly believe that a disciplined approach to selling securities is just as important as a rigorous approach to buying them.

Our sell price is determined at the time we decide to make an investment as part of our analytical process. Once we make the purchase we patiently wait for the shares to meet this target price. When our expectations are met we sell the shares.

We believe that this disciplined approach is extremely important. Selling at intrinsic value reduces both security and overall portfolio risk. In addition, locking in profits allows us to protect and grow your capital, while allowing for the potential reinvestment in other more attractively priced and lower risk opportunities.

It should be noted that after we sell our shares their price often continues to go up. We strongly believe that holding securities at prices above their intrinsic value is speculation. From our perspective we have achieved our objectives and are more than happy to "cash in". The increased share price is of no concern to us.

We have been fortunate as the vast majority of our sell decisions have been because our investments have reached their intrinsic value and thus our target price. However, there may be occasions when we sell for one or more of the following fundamental reasons:

- ✓ **a significant change in the competitive environment**
- ✓ **a change in strategic direction**
- ✓ **large and expensive acquisitions**
- ✓ **adoption of aggressive accounting policies**
- ✓ **a negative change in capital structure**

These situations most often reduce a company's value and/or increase risk.

Once we identify any of the above issues we thoroughly analyze our investment again and sell the shares if our analysis indicates that the concerns are justified.

We have found that the most frequent "red flag" and cause for concern have been corporate acquisitions. We get very nervous when one of our investee companies makes a large purchase. Several academic studies and practical experience show that approximately seventy five per cent of all acquisitions result in disappointment and that the expected benefits fail to materialize.

Typically these acquisitions are made at very expensive prices and are justified by supposed strategic and cost synergies. To make matters worse these purchases are often financed in such a way that dilutes the company's per share intrinsic value and/or increases financial and operational risks.

In most cases when such announcements are made, the short term market reaction is positive and the shares of the acquiring company increase in value. We take this opportunity to sell into the enthusiasm, as we are no longer interested in partnering with a management team that is focused on corporate size rather than shareholder returns.

Thanks to your confidence and trust we have grown quite dramatically over the last two years. PCM's assets under management now approximate four hundred million dollars. In our discussions with you we promised that we would control our growth so that you would always have direct contact with Domenic and me.

We want to ensure that your access to us and our ability to respond to your needs quickly is not compromised. Effective June 30, 2013 we are increasing our minimum new segregated client size to one million dollars. While this decision may slow PCM's growth it is far more important that we maintain our high level of service and commitment to you.

A promise made is a promise kept!

Vito Maida
February 21, 2013