YOSEMITE CAPITAL MANAGEMENT

Second Quarter 2015 – COMMENTARY

In the business world, the rear view mirror is always clearer than the windshield. – Warren Buffett

For the vast majority of investors, their broad long-term ***strategic asset allocation***, which is the portion of their portfolio directed into major asset classes, determines the bulk of the returns they ultimately receive over an investing lifetime and the amount of volatility their portfolio experiences. Typical major asset classes are stocks, real estate, and bonds.

Investment results can be refined somewhat through intelligent ***tactical asset allocation***, which is the portion of a portfolio directed into subsets of the broad categories. Examples of subsets of stocks are domestic/foreign, large/small companies, and sectors. Real estate subsets include foreign/domestic, equity/mortgage, and office/industrial/residential/retail. Subsets of bonds include domestic/foreign, government/agency/municipal/corporate, investment grade/high yield, and short-/intermediate-/long-term.

The portfolio construction process is completed with ***security selection***, the particular pieces of a portfolio which the money actually purchases. As it turns out, with only a few exceptions security selection adds very little to long term returns, and for many people (perhaps the majority) actually detracts from performance. This is highly ironic because much of the focus of the investment world is on this aspect.

Over the long term of many years, ***portfolio returns and risks are inextricably linked***. Generally, for efficiently designed portfolios higher returns in competitive markets can only occur by accepting higher risks. However it is NOT true that taking higher risks means higher returns automatically follow.

There are many types of risks that investors face, including volatility, purchasing power, interest rate, company-specific, default, liquidity, currency, and political, to name just a few. It is important to remember that ***risks cannot be eliminated*** because all asset classes, sub-classes, and securities contain some risks of some sort. Reducing one type often requires increasing another type. Even though risks cannot be eliminated, successful investors know that ***risks can be managed***.

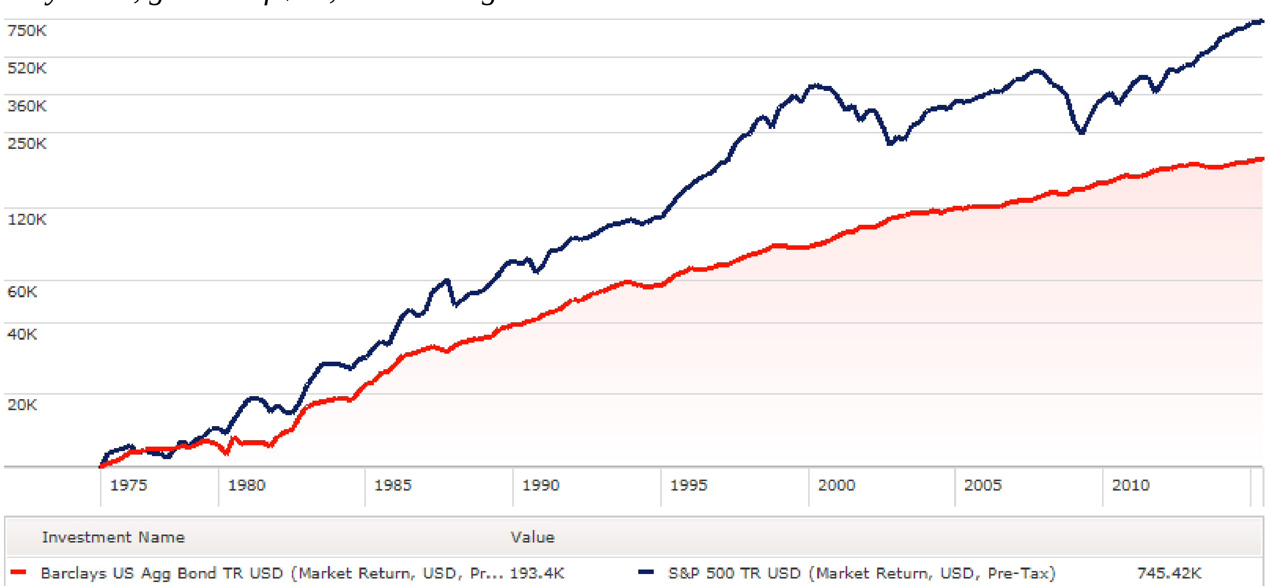
One of the easiest and most cost-effective ways of managing risks over time is having a sufficient amount of ***diversification*** across asset classes, sub-asset classes, and securities. Diversification is holding several different assets that have negative or low correlations with each other. Doing this is important for the very simple reason that ***no one can predict the future of the financial markets with consistency and reasonable precision***. The effect is that over the course of several market cycles an investor reduces risks for a given amount of returns, all relative to their individual goals and objectives. Diversification cannot prevent periodic temporary declines in a portfolio, but it can mitigate such declines so that a portfolio has higher odds of recovering quicker so that an investor can still meet their long term goals.

The importance of a sufficient amount of diversification cannot be over-emphasized. But this begs the question as to how much is too little and how much is too much. Alas, there is no simple or easy answer to this question. However, market history (our favorite teacher) can provide guidelines as a starting point, at least for asset classes and many sub-asset classes.

To take an overly simplified example, note how domestic stocks (as represented by the S&P 500 Index) and domestic bonds (as represented by the Barclays U.S. Aggregate Bond Index) have fared over decades (see Exhibit 1). From there, one can infer how different combinations performed during periods of economic recession and other market disturbances. A portfolio with a higher proportion of stocks versus bonds would have higher returns but also a higher amount of volatility, which demonstrates our point above that ***portfolio returns and risks are inextricably linked***. This would give an investor an idea of what combinations might and might not meet their long term goals as well as provide an indication of how much portfolio volatility is necessary to tolerate along the way to meet those goals. Of course it is imperative to understand that most common yet easily dismissed disclaimer "*Past performance is not indicative of future results*."

Exhibit 1

S&P 500 Index (blue line) and Barclays Aggregate Bond Index (red line) since December 1975 through May 2015, growth of $10,000 on a logarithmic scale



Source: Morningstar

Such an exercise will point out that during sometimes long stretches one asset class or another will seem to be a drag on a portfolio, yet other times during market upheavals the roles will reverse. That is the point of diversification. In fact, ***a properly diversified portfolio will always have something "not working" or disliked.*** The corollary to this is ***the lack of something "not working" in a portfolio could actually be a very strong symptom of not being diversified enough***. Put another way, if everything in a portfolio is going up during a bull market, they are very likely to all go down in a bear market.

But portfolios can have too many sub-asset classes and/or securities with the effect that they reduce portfolio returns. This situation is described as ***"diworsification"***, a term coined by Peter Lynch in his book "One Up on Wall Street". (He was describing a business that diversifies too widely, which risks destroying their original business, because management time, energy and resources are diverted from the original investment. His point is very applicable to investment portfolios.)

Over-diversification happens because of ignorance (insufficient education about portfolio management) and fear (real or imagined), frequently both together, with the thinking that more is better. And ignorance and fear, especially when combined, is something that Wall Street sniffs out and preys upon for its own benefit by creating new products for its vast marketing and sales apparatus. These products purport to solve every possible problem, but because reducing one type of risk often requires increasing another type of risk, buying them to contain any and all risks turns portfolio management into a game of whack-a-mole. The result is that one or more serious risks remain dangerously standing and portfolio returns suffer. This defeats the whole purpose of investing!

There are many examples:

> Fear of stock market volatility? Buy alternative strategies (long/short, market neutral, absolute return, managed futures, arbitrage, etc.), non-traded real estate investment trusts (REITs), or a get-rich-quick scheme instead of owning stocks.
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> Fear of a stock market crash? Buy an annuity or put options or stay in cash instead of owning stocks.
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> Fear of weak domestic economic growth? Buy foreign stocks instead of owning domestic stocks.
>
> Fear of low interest rates? Buy Master Limited Partnerships (MLPs), high yield (junk) bonds, real estate investment trusts (REITs), high dividend stocks, covered call options, or second trust deeds instead of owning investment grade bonds.
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> Fear of rising interest rates? Buy floating rate bonds, ultra-short duration bonds, and inverse exchange traded notes (ETNs) instead of owning intermediate- and long-term bonds.
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> Fear of rising inflation? Buy gold and other hard commodities instead of owning bonds.
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> Fear of a falling or collapsing dollar? Buy gold, oil, foreign bonds, and foreign currencies instead of owning domestic bonds.
>
> Fear of a domestic economic collapse? Buy gold, foreign stocks, foreign bonds, and foreign currencies instead of owning anything domestic.

It is one thing for novice investors to over-diversify, but it is absolutely disgraceful and inexcusable when so-called professional investors do this on behalf of clients. We have seen this first hand from several prospects recently referred to us by our clients (thank you!). Their portfolios have had poor returns, no discernable long-term strategy, and (no surprise) are significantly comprised of items from the list above.

Other than non-traded real estate investment trusts and get-rich-quick schemes, there is nothing necessarily wrong per se with most items in the list. We use some of them in some client portfolios depending on the clients' situations, we have used some of these in the past, and we could very well use some of them in the future. But these should NOT be used to the point where they dominate a portfolio and negate returns. Taking the basic meat and potatoes of a portfolio and adding some spice is one thing, but replacing meat and potatoes with a portfolio of spices will not provide financial sustenance.

As the saying goes, every dog has his day, and WHEN the next bear market happens – it will! – some portfolios containing the alternative and esoteric may look pretty good. But there is no point of having good returns during a temporary short-term situation when they have poor returns over the long term.

Having the discipline to maintain the appropriate strategic asset allocation with sufficient diversification will be the most effective risk-management tool an investor can employ. Keeping a long term perspective by understanding the huge difference between a temporary portfolio decline and a permanent loss of capital will enable investors to not just tolerate bear markets but actually take advantage of them.

Successful investors are not driven by fear. True, things are not perfect or fair and the future is not clear. But things have never been perfect or fair and never will be, and the future has never been clear and never will be. But if ever in human history there was a time and place to live life well and be optimistic about the future, the United States of America in our lifetimes is it. Though we cannot trade the time we live, we have the freedom to trade the place where we live, and we are not going to make that trade.

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We remind clients and friends that all of our commentaries are available on our web site (http://www.YosemiteCapital.com/News-Commentary). As always, please contact us if you have any questions.

The S&P500 Index is designed and maintained by Standard & Poor's (a division of The McGraw-Hill Companies), is a free-float market capitalization weighted index that includes 500 leading companies in leading industries of the U.S. economy, and is intended to be an ideal proxy for the total market. This index is calculated on a total return basis with dividends reinvested and is not available for direct investment.