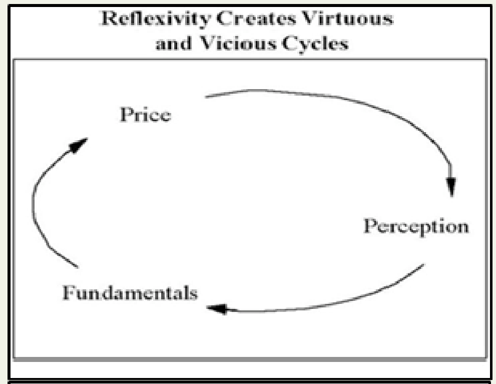
Q4 2014 Market Review & Outlook

Morgan Creek Capital Management

Letter to Fellow Investors

Reflexivity: The Virtuous & The Vicious



Equilibrium Theory	Reflexivity Theory
Information becomes immediately available to everyone	People act on incomplete information
People are rational actors	People are influenced by their biases
Economic systems go quickly to equilibrium	Social systems display boom and bust cycles
A theorist is outside the system observed	Observers are part of the system observed
Theories do not alter the system described	Theories are a means to change the system described

Source(s): Quora.com.

Due to a coincidence of the calendar, I write my Q4 letter each year during Super Bowl week and the hype surrounding the event has provided inspiration in prior years for the theme of the letter from the 2013 HarBowl (Brothers Jim and John faced off as opposing coaches) where we talked about how Defense Wins Championships (defense ruled again on the last play of this year's game, unfortunately for us Seahawks fans) to the improbable run of Kurt Warner with the Cardinals in 2009 where he was nearly run out of town for a run of poor performance early in the season before confounding his skeptics and leading them to the Super Bowl (which they should have won, but for one of the most amazing passes in Super Bowl history by Ben Roethlisberger). Warner's heroic performance was another reminder that recent performance is not a good predictor of future returns despite the predilection for investors to pick managers that way. There was clearly a lot of great material for investment lessons in the 2015 Super Bowl to come up with a theme for this letter, from the rise of two underrated quarterbacks (late round draft picks) who have become the best in the game despite all the quantitative analysis that predicted they would never amount to much (statistics still can't measure heart and field smarts), to the unlikely rookie hero who didn't forget that you have to stay focused on every snap because you never know when the ball is coming your way (even when everyone else in the stadium knew, for sure, it was going to be a run, not a pass, on the last Seahawks play; well, everyone but Pete Carroll), to defense wins championships again as it was the Patriots defense that kept the prolific Seattle offense out of the end zone in the fourth quarter which allowed Tom Brady's heroic performance (Super Bowl records for most completions and most all time TD passes) to become MVP worthy rather than a footnote in stories about Russell Wilson's MVP award, to the importance of understanding the difference between probabilities and possibilities when making critical decisions, in football and in investing (it was possible that a slant pattern would work when everyone was crushed together at the one yard line, but it was probable that Marshawn Lynch (#BeastMode) would get the last yard given three downs and a timeout…). But, this year, we will take a break from the football analogies and talk about an MVP worthy performer in the investment business that has provided many pearls of wisdom (and a little philosophy) over the years that we can apply to the current investment environment.

George Soros is widely regarded as one of the preeminent investors of our time after compiling a track record over four decades from 1969 to 2009; that is, without question, Hall of Fame material. Given that there are simply not that many investors who have track records of this duration, it is tough to make direct comparisons at all, and making comparisons across decades is tough because of the very different economic and market environments that exist from decade to decade. For example, making good returns from 1969 to 1982 was pretty darn tough as the S&P 500 was essentially flat during those 14 years, while it was pretty easy to make solid returns from 1982 to 2009 as the S&P 500 compounded at 12.3% and went up nearly 20 times (when you put the whole 41 year period together the S&P 500 compounded at 9.4% and turned a $10,000 investment into just under $400,000). Interestingly, there is one investor who was in the market the entire time as Soros (and is often touted as the world's greatest investor, for some pretty good reasons related to consistency and longevity) and actually has a track record that we can stack up side by side with George to gain some perspective. Warren Buffet closed his private partnership (BPL) to new capital in 1966 and, by 1969, had transitioned to running as a closed end fund named Berkshire Hathaway (named after the original textile manufacturer that he bought a controlling interest in and later took outright control). So when Soros started taking outside capital into his Double Eagle partnership in 1969 (where he was an Associate at Arnhold and S. Bleichroeder), we had ourselves a horserace. George eventually spun himself out in 1973 into a private firm, Soros Fund Management, and later established the Quantum Fund as their primary investment vehicle. Soros was the primary Portfolio Manager for many years, but was very successful in building an extraordinary team of very talented investors to work at Quantum and he eventually ceded the CIO responsibilities to Stanley Druckenmiller (who also has a Hall of Fame track record of his own in compounding client wealth in his fund, Duquesne Capital). Soros became less active in the late 2000s and Quantum actually returned all outside capital in 2011, converting to a Family Office to concentrate on running the Soros family and Foundation assets.

So for the 41 years from 1969 to 2009, we have good data on Quantum vs. Berkshire (thanks to Veryan Allen at @hedgefund who collected the information and calculated the returns) and the results are nothing short of astonishing. Warren compounded wealth over that period at a stunning 21.4% (more than double the S&P 500 return over the period) and would have turned a $10,000 investment into $28.4 million. Soros, however, did a just little bit better, compounding at 26.3% (which doesn't sound like that big a difference) and, through the miracle of long-term compounding, turned that same $10,000 original investment into an extraordinary $143.7 million. Now clearly very few investors benefitted completely from any of these three track records. Those numbers assume that you reinvest all the dividends, never take any distributions and invested at the beginning and stayed invested until the end. Forty-one years is a long time to stick to one strategy. In fact, to provide some perspective on how hard it is to stick to any strategy long-term, we have data that shows that over the past 20 years (a period only half as long as the Soros period) the S&P 500 Index has compounded at 8%, yet the average investor in mutual funds has only made 3% (from the Dalbar Study) because investors are not very good at sticking to a strategy and letting compounding work for them. As famous stock operator Jesse Livermore once said, *"It was never my thinking that made the big money for me, it was always my sitting."* Understanding full well that most investors only earn a fraction of what is available in any investment strategy, simple math says that a fraction of George or Warren's performance is far superior to a fraction of the S&P 500 performance. The primary point of all of the performance math here is to establish that George Soros is one of the world's greatest investors and we would probably be wise to pay attention to any lessons he is willing to share with us and, fortunately, he has been willing to share many of them over the years. I have compiled a collection of "Sorosisms" from various sources over the years and have tweeted many of them individually to provide insight on a particular event or opportunity in the market, but for this letter I have selected my favorite 23 (many from a great compendium of 50 of George's best at thinkinginvestor.com) to discuss the Soros philosophy of Reflexivity and make the case for why it is so important for investors to understand, particularly today.

George Soros was born on August 12, 1930, as Schwartz György, in Budapest, Hungary. His father later changed the family name from Schwartz ("black," in German) to Soros ("will soar," in Esperanto). Soros survived the Nazi occupation of Hungary and moved to England in 1947 where he enrolled at the London School of Economics and became a student of the philosopher Karl Popper. In 1951, he earned a BSc in Philosophy and in 1954 he completed a PhD in Philosophy. Soros was deeply impacted by his mentor and embraced core tenets of Popper's teachings including the Human Uncertainty Principle (a foundational element of Reflexivity) and the Advocacy of Falsification (the construct that empirical truths cannot be proved conclusively by observation, but they can be falsified). The popular concept of the Black Swan is an example of the Falsification construct. The idea that all swans are white cannot be validated by the observation of white swans (no matter how many white swans one observes), but it can be falsified by the observation of a singe black swan. Popper's theories were rooted in the ideas of Human Fallibility (the idea that thinking participants' knowledge of any situation is always partial and distorted by their biases and misconceptions) and Complexity Theory (the idea that the world is more complex than our capacity to understand it), which, ultimately, led to the concept of Reflexivity (that participants partial, biased or false views led to inappropriate actions that impacted the actual system in which the participants are interacting). To Popper, Human Uncertainty arose from two notions: 1) that it was impossible to know what others know, or don't know, and 2) that other participants may have different interests, or values, relating to the system in which you are engaged. Soros concluded that his newly found core philosophical tenets contradicted the ideal of perfect knowledge existing in markets or economics and began to develop his own philosophy based on the idea of imperfect understanding. Soros came to embrace the idea that there is a two-way interaction between the Cognitive (how we understand the environment in which we interact, how reality determines our view) and the Manipulative (how we change the environment in which we interact, how our intentions impact the world). In essence, he postulated that the actions we take are influenced by how we perceive the environment (which, by definition will be skewed by our biases or lack of complete information, he called these fertile fallacies) and those inappropriate actions, in turn, impacted the environment, which would then change our subsequent view (in an endless feedback loop). The notion of evolution would lead to continuous, self-reinforcing cycles (both virtuous and vicious) that he reasoned could explain the boom/bust cycles observed in financial markets.

The principle of Reflexivity is based on the construct that markets tend toward disequilibrium, rather than equilibrium, because the actions of the participants are exaggerated by their biases, or misconceptions, about the market itself and their subsequent actions then change the valuation of those markets which further reinforces those biases in a self-reinforcing feedback loop. Soros does not mince words when he says, ***"the concept of a general equilibrium has no relevance to the real world (in other words, classical economics is an exercise in futility)."*** As the picture above summarizes, Reflexivity Theory (RT) is fundamentally different from classical Equilibrium Theory (ET) on five primary levels: 1) ET makes the assumption that market participants have instantaneous access to perfect information, while RT says that market participants act on imperfect information, 2) ET assumes that markets are composed of rational actors, while RT acknowledges that market participants are influenced by their own biases and misconceptions, 3) ET relies on the construct that markets move quickly and efficiently toward a state of equilibrium, while RT says that markets are dominated by states of disequilibrium resulting from feedback loops that lead to virtuous (boom) and vicious (bust) cycles, 4) ET says that market theorists and observers are external to the system, while RT says that all members of the system are part of the market observed, and 5) ET assumes that the theories on the markets do not influence, or change, the markets while RT believes that market theories are a direct means of changing the systems described. Soros would clearly not have been a fan of the economic theory I was subjected to at the University of Chicago (the center of the Efficient Markets Hypothesis (EMH) universe) and would argue that ivory tower economic theory replete with simplifying assumptions about rational expectations and perfect information are a waste of time for investors who must earn their living in the real world. He would argue that markets are highly IN-efficient, spending the bulk of the time in varying states of disequilibrium, resulting in many opportunities for investors to earn excess returns. Given his track record of generating excess returns, it is hard to refute his logic. In reflecting on this point, one hypothesis could be that the core philosophy an investor adopts could (in a Reflexive manner) actually increase the likelihood that they achieve excess returns over time. Similar to how an outstanding golfer increases the odds of hitting consistently good drives by visualizing hitting down the middle of the fairway in advance, while the duffer consistently slices into the woods by worrying about slicing into the woods as they address the ball. If we believe that we will earn excess returns by understanding the cyclical nature of markets and their reflexive response to participants' collective actions, perhaps we can exploit those opportunities more effectively rather than be exploited by them.

When John Burbank from Passport Capital spoke at our iCIO event, the title of his speech was "Price is a Liar," a concept that Soros expounds upon when he says, ***"the generally accepted view is that markets are always right, that is, market prices tend to discount future developments accurately even when it is unclear what those developments are. I start with the opposite view. I believe the market prices are always wrong in the sense that they present a biased view of the future."*** The construct here is that in a Reflexive world, where markets tend not toward equilibrium, but toward disequilibrium, the current price of a security is not a reflection of "fair value" as the Efficient Markets Hypothesis would have us believe, but rather a temporary "unfair value" driven by the virtuous, or vicious, cycles created by market participants' misperceptions and the resulting collective inappropriate actions that come from participants acting on those misperceptions. A perfect example of this phenomenon could be seen at the peak of the equity market in March of 2000 when investors had a collective misperception of the value of technology companies like Microsoft and Cisco (and many other even more outrageously valued names) and investors were willing to pay a price for CSCO shares that in the EMH world were completely logical and reflected the discounted future value of future earnings for Cisco. *The Wall Street Journal* ran a headline story saying Cisco would be the first $1 trillion market cap company (a feat that still has not been achieved, although Apple is getting closer at $693 billion today) and jubilant investors were happy to pay $286 for every $1 of earnings that Cisco generated in 1999. Just for some perspective on why price is clearly a liar, it would take Soros nearly 25 years to compound $1 into $286, Buffet would need 29 years and if we had to wait for the average return in the S&P 500, it would take almost 60 years. Soros was right (as usual) and the CSCO market price was wrong, the tech bubble crashed, investors like Quantum cleaned up being short those companies and today, 15 years later, CSCO stock is still down (65%) from that peak valuation. Cisco's market cap is only $139 billion (down from the peak of $555 billion) and it is highly unlikely that will ever hit $1 trillion, as Hauwei in China has a different plan on which global company will dominate the network equipment space in the future. To show Reflexivity in action, not one of the 37 Wall Street Analysts at the time had Cisco rated anything lower than a "Buy" or "Strong Buy" (not a "Hold" or "Sell" anywhere to be seen) at the precise peak in the stock, a stock that would then essentially decline nearly in a straight line for the next decade and a half.

Soros speaks specifically about the challenge of misperceptions when he says, ***"being aware of Reflexivity, genuinely, I am often overwhelmed by the uncertainties. I'm constantly on watch, being aware of my own misconceptions, being aware that I'm acting on misconceptions and constantly looking to correct them. Misconceptions play a prominent role in my view of the world."*** The reality is that we will never have complete information (contrary to conventional Equilibrium Theory); in fact, it is highly unlikely that we will even have a high level of good information at the moment we are faced with the majority of decisions we must make. We are continually surrounded by uncertainty and our brain actually works against us in this regard (just to make things even more challenging). Our brains are constantly bombarded with hundreds of impulses and pieces of information to process; however, the physiology only allows for the processing of seven or eight impulses, so our brain actually increases our distortion/misconception by excluding the bulk of the available information and selectively highlighting and processing the most accessible, most familiar, or most (the worst) closely aligned with our current beliefs. The last part is so dangerous because the way we should create a belief is by gathering all available information, examining it and then deciding. Unfortunately, the human brain does exactly the opposite, it forms the belief and then excludes any information that contradicts that belief, unless we actively override and force the evaluation of alternative views and ideas (explains the preponderance of extreme views on politics, religion and many other areas). Without taking the active approach to not only acknowledge, but to proactively understand and evaluate your misconceptions, as Soros describes above, it is highly unlikely that you will break free of the cyclical behavior of the herd (which can be extremely harmful to your results as an investor).

So as human beings continually act on their misconceptions, Reflexivity says that those actions then begin to distort the financial markets themselves, which then can actually impact the actual fundamentals of the markets themselves. Soros says ***"I contend that financial markets never reflect the underlying reality accurately; they always distort it in some way or another and the distortions find expression in market prices. Those distortions can, occasionally, find ways to affect the fundamentals that market prices are supposed to reflect."*** Again we can look to the technology bubbles (2000 and again in 2014) to see how this reflexive pattern works. As the prices of stocks in the technology sector run up, investor perceptions of the potential impact of those technologies (and companies) begins to grow in an exponential fashion. As the mania spreads, more money is attracted to the industry and the price of stocks rises at a rising rate. The ever higher valuations of the companies allows them to do things that actually impact their fundamentals such as acquiring competitors (reducing competition and increasing pricing power) or issuing more equity or debt capital (expanding the resources of the most powerful firms to grow, create new products and services, and increase competitive position). Both of these activities actually lead investors to pay an even higher valuation for those "winners" as the market participants' perception of the companies rises in a virtuous cycle (enabled by precisely those higher valuations).

Soros has described how this virtuous cycle can lead to market bubbles, driven by Reflexivity: ***"stock market bubbles don't grow out of thin air. They have a solid basis in reality, but reality as distorted by a misconception. Every bubble consists of a trend that can be observed in the real world and a misconception relating to that trend. The two elements interact with each other in a reflexive manner."*** So let's go back to our tech bubble example. There is no debating the reality that the technology boom that surged in the late 1990s, when many of the great franchise companies in the technology industry like Microsoft, Cisco and Yahoo boomed, led to a massive surge in productivity, innovation and wealth creation. These companies were selling lots of hardware, software and services to help companies migrate from the Client/Server platform and the future looked very bright for the transition onto this new, new Thing called the Internet. The problem was that the reality of the Internet was indeed bright, but investors' reality was distorted by the mania surrounding the current dominance of these leading companies and they were willing to pay any price (regardless of fundamental values) to "not miss out." Investors believed that these companies would remain dominant and they had a misconception that the timeless rules of Capitalism (high profits attract competition) and Creative Destruction (innovation continues and new companies surpass the old leaders) no longer applied. It was another perfect example of Sir John Templeton's four most dangerous words in investing "This Time It's Different." It never is different, and it wasn't in 2000 (or again in 2014) as the positive trend elicited investor behavior that drove the market to bubble levels, as the reflexive interaction of rising prices and investor enthusiasm created an extreme virtuous cycle (the worst bubble we have ever seen in U.S. equities with P/E ratios in the 40s). In fact, at the peak of the bubble, the market capitalization of those three companies was $1.3 trillion and instead of rushing to sell those ridiculous valuations short, the opposite occurred and a stunning amount of capital, equivalent to 85% of all the money ever invested into technology focused mutual funds up to that point, flooded into the market in the first four months of 2000, rushing to buy, not sell these bubblicious names. As Paul Harvey says, you know "the rest of the story": the markets peaked and crashed over the next three years; NASDAQ fell close to (80%) and over $5 trillion of wealth was vaporized. Today, the collective market cap of MSFT, CSCO and YHOO is $555 billion, an amazing (60%) decline over fifteen years.

We have written in previous letters about Charles Kinderberger's seven-year cycle of booms and busts that follow the business/economic cycle, which results from the interplay between "Insiders" (those with the greatest knowledge of companies like owners, management and professional investors) and the "Masses" (those with the least knowledge about companies like retail investors and rules based funds). The Insiders sell assets to the Masses at the top of markets at peak prices and the Masses sell those same assets (at a much lower price) to the Insiders at the bottom of the market. We saw this cycle play out over the seven years from 2000 to 2007 where we run into the next example of Reflexivity writ large. One of the most direct reflections of Reflexivity in the markets that Soros found in his work was the relationship between credit and collateral. He said, ***"I made two major discoveries in the course of writing: one is a reflexive connection between credit and collateral, the act of lending can change the value of the collateral, the other is a reflexive relationship between regulators and the economies they regulate."*** The housing bubble that was created in the U.S. in the mid-2000s was a case study in how the expansion of credit (Dr. Greenspan encouraging everyone to get bigger mortgages) can reflexively change the value to the collateral being lent against. Housing prices surged ever higher as greater credit availability increased the demand for homes by bringing a greater number of buyers into the market. Only later did it dawn on investors that the incremental buyers were called "Sub-Prime" for a reason and they were not as likely to repay those loans as the Prime borrowers had been historically. Once again, the participants in the market had their reality (prices should rise as demand surges) altered by a misconception that all homebuyers were of equal quality and durability.

Soros goes on to say that ***"money values do not simply mirror the state of affairs in the real world; valuation is a positive act that makes an impact on the course of events. Monetary and real phenomena are connected in a reflexive fashion; that is, they influence each other mutually. The reflexive relationship manifests itself most clearly in the use and abuse of credit. It is credit that matters, not money (in other words, monetarism is a false ideology)."*** As the valuation of homes continued to rise, there was a reflexive response by borrowers to reach for larger homes (prices could only go up, so more opportunity to make huge profits), which further increased the demand for credit. As banks could no longer retain that much risk on their balance sheets, they found ways to securitize the loans and distribute the risk to other market participants. This provision of new securities created another reflexive response in the creation of leveraged pools of these "safe" securities (or so the models said they were safe) and that allowed the banks to further expand their lending activities. Then the second part of the Soros discovery came into play as the Regulators reflexively relaxed the rules for the creation, distribution and valuation of these securities, leading to increased demand and the virtuous cycle was set into overdrive. Banks could hold unlimited amounts of these securities in the absence of mark-to-market risk and another Soros quote applies here that ***"whenever there is a conflict between universal principles and self-interest, self-interest is likely to prevail."*** The universal principle that there should be a relationship between risk of loss and provision of new loans was overridden by the self-interest of originating as many loans as possible to generate high fees, knowing that the risk could be sold to other investors through securitization (creating more fees and more self-interest). In the mad scramble for loan creation during the final phase of the Housing Bubble, the government created an environment of essentially free money by allowing the big agencies, Fannie Mae and Freddie Mac (or Phony and Fraudie, as I often affectionately refer to them) to securitize loans to the bottom of the barrel risks with crazy terms like no money down and incredibly low "teaser" interest rates. Soros has a comment that applies here as well, ***"when interest rates are low we have conditions for asset bubbles to develop. When money is free, the rational lender will keep on lending until there is no one else to lend to."*** That is exactly what happened, the lenders exhausted the pool of borrowers, the reflexive impact of rising demand pushing prices higher began to wane and the virtuous cycle turned dramatically (as they always do eventually) into a vicious cycle that triggered the Global Financial Crisis and those same banks that made all the ill-advised loans were crushed by massive losses related to the reflexive expansion of credit. Then, yet again, what were Mr. Kindleberger's "Masses" doing at the peak? Why, of course, they were loading up on index funds, that were loading up on what had run the most (in classic reflexive fashion), the banks and financials, so when Citi and BofA fell (95%) and Phony and Fraudie fell (99%), investors learned, yet again, that price is a liar.

Reflexivity is rooted in uncertainty, and it is that uncertainty which leads to the dramatic misconceptions of market participants who push markets to extremes, resulting in the booms and busts we have all experienced over the years. Soros has an important belief related to this construct, that ***"the financial markets generally are unpredictable. So that one has to have different scenarios... The idea that you can actually predict what's going to happen contradicts my way of looking at the market."*** They say risk defined more things that CAN happen than WILL happen and he contended that the idea that anyone could consistently pick out which of the myriad outcomes is likely in the financial markets over time was folly. Despite the challenge of divining the future, his investment strategy was not to do nothing (for fear of being wrong). On the contrary, he would acknowledge the uncertainty, as well as his own biases and misconceptions, and boldly make decisions and investments. He states very clearly, ***"you have got to make decisions even though you know you may be wrong. You can't avoid being wrong, but by being aware of the uncertainties, you're more likely to correct your mistakes than the traditional investor."*** He then goes on to explain why it is so hard for most investors to admit when they are wrong, to accept that they have made an error, and to correct the error before it grows into a more costly mistake. I have been fortunate to interact with many of the very best investors in the world, to talk about their investment strategies, and all of them talk about the ability to limit the losses when you make a mistake. Soros, as always, thinks about the concept with a philosophical perspective, ***"once we realize that imperfect understanding is the human condition there is no shame in being wrong, only in failing to correct our mistakes."***

Making mistakes as an investor is inevitable, but failing to correct your mistakes is inexcusable and can, in the worst circumstances, be cataclysmic to your wealth. Soros has also stated very clearly why this concept is perhaps the most important concept in investing in saying ***"I'm only rich because I know when I'm wrong. I basically have survived by recognizing my mistakes. I very often used to get backaches due to the fact that I was wrong. Whenever you are wrong you have to fight or take flight. When I made the decision, the backache went away."*** Being wrong means you are losing money. Losing money means you are eroding the power of compounding, and given George's amazing long-term track record of compounding, he clearly never stayed in pain very long. You can't compound at 26.3% (for any period, let alone 41 years) if you don't recognize your mistakes and take swift and decisive action to correct your errors. Peter Lynch was famous for saying that the best way to make money was to "let your flowers grow and pull your weeds" (another way of saying fix your mistakes). The problem is that most investors do the opposite, they pull their flowers at the first sign of making a profit and they let their weeds grow because they are too proud to admit they are wrong or too stubborn in wanting to show the world that they are right. On the flip side, Stanley Druckenmiller, who worked for Soros for many years has been quoted often in describing the most valuable lessons he learned from his mentor and said, *"I've learned many things from him, but perhaps the most significant is that it's not whether you're right or wrong that's important, but how much money you make when you're right and how much you lose when you're wrong. The few times that Soros has ever criticized me was when I was really right on a market and didn't maximize the opportunity. Soros has taught me that when you have tremendous conviction on a trade, you have to go for the jugular. It takes courage to be a pig. It takes courage to ride a profit with huge leverage. As far as Soros is concerned, when you're* *right on something, you can't own enough."* I love so much about this quote because it encapsulates so much investment wisdom and should be a mantra for any investor striving to achieve long-term success. Investing is not about ego; it is not about being right; it is about making money. Great investors don't care about being wrong -- they correct mistakes and move on, they focus on the next play, not the last play. But most importantly, great investors know when they have an edge and they are not afraid to push their position. The difference between poor investors and great investors is "Losers Average Losers" and "Winners Press Winners." I have written about this before, but every Tiger Cub I have ever talked to has said the same thing about the Big Cat (Julian), *"he had an uncanny knack to double, UP."* Another great quote, from Peter T. McIntyre, is applicable here, *"confidence comes not from always being right, but from not fearing to be wrong."*

Another unique aspect of the Genius of George is that he was not a "Value Guy" or a "Growth Guy" or an "Activist" or any other label, in fact he says quite emphatically, ***"my peculiarity is that I don't have a particular style of investing or, more exactly, I try to change my style to fit the conditions."*** In the true spirit of Reflexivity, being responsive to the environment and taking advantage of trends when they are trending or capitalizing on distress when it exists has earned Soros a reputation as simply being a great Investor (with a capital I and no modifier). Given the constant change in the markets, the ability to change your approach to capitalize on those opportunities provides greater upside than investing alongside the masses. Soros commented on this when he says, ***"markets are constantly in a state of uncertainty and flux, and money is made by discounting the obvious and betting on the unexpected."*** If you do what everyone else is doing, it is unlikely you will make outsized returns. Michael Steinhardt (another Hall of Fame investor) talks about the concept of Variant Perception (a view that is meaningfully different from the consensus) and would agree with Soros that all his big profits came from investing in unexpected outcomes that turned out to be right. From seeding small managers in Thailand and supersizing their best ideas to giving a manager $500 million after they had lost more than 70% during the Russian GKO Crisis in 1998 (when all the "blue chip" investors were redeeming, yes, Soros doubled his money in less than a year) to breaking the Bank of England for a cool billion dollar over-night profit, Soros is an investment chameleon who has thrived on betting on the unexpected and winning. Chameleons change to blend into their surroundings to survive and Soros has said ***"if I had to sum up my practical skills, I would use one word: survival. And operating a hedge fund utilized my training in survival to the fullest."*** Soros survived a Nazi occupation of Hungary and a myriad of life struggles in his path to establish a unique investment philosophy rooted in the Darwinian ideal of survival of the fittest (adapt or die) and that philosophy and strategy has produced one of the world's greatest investment track records.

Bringing the conversation back to Reflexivity, it is interesting to listen to Soros talk about some of the philosophy and strategy they utilized at Quantum and how they would exploit their understanding of the reflexive process in markets to capture investment opportunities. In describing Soros Fund Management, he said ***"we try to catch new trends early and in later stages we try to catch trend reversals. Therefore, we tend to stabilize rather than destabilize the market. We are not doing this as a public service. It is our style of making money."*** Interestingly, his comment contradicts the conventional wisdom that hedge funds are a destabilizing factor in markets as Reflexivity Theory shows us that it is the markets that trend toward disequilibrium and that organizations like SFM actually help provide stability. It is also interesting that he states very clearly that the goal is to extract economic rents (make money) by capitalizing on the collective errors of the broad market participants following the boom/bust cycles, constantly buying what they wish they would have bought and selling what they are about to need (like those investors selling hedge funds today to chase the hot returns that index funds achieved over past five years). One of my personal favorite Soros quotes is that ***"it does not follow that one should always***

go against the prevailing trend. On the contrary, most of the time the trend prevails; only occasionally are the errors corrected. Most of the time we are punished if we go against the trend. Only at an inflection point are we rewarded." So often people incorrectly label great investors as contrarians, or vultures, and think they simply lay in wait for some big dislocation and pounce, but Soros says that the bulk of the returns come from patiently sitting (the Jesse Livermore word again) and riding the trends toward the extremes that are created by the reflexive process in the markets. Most investors miss the majority of the gains available in a trend because they doubt the persistence of Reflexivity and the relative infrequency with which the collective errors are corrected.

Now, precisely because the trends will go to extremes, it is critical to be on the lookout for the inflection points and be ready to reverse your position. Soros describes it this way, ***"this line of reasoning leads me to look for the flaw in every investment thesis. I am ahead of the curve. I watch out for telltale signs that a trend may be exhausted. Then I disengage from the herd and look for a different investment thesis."*** The continual "Devil's Advocate" approach maintains a discipline to not fall in love with your own idea or analysis and let the market tell you when it is time to modify your hypothesis. Perhaps it was Soros' training in philosophy and his mentorship under Karl Popper that ingrained in him a discipline to continually test his theses and respect the human uncertainty that allows one to be ego-less and move onto the next idea. Soros describes one of the ways in which you may be able to tell when a trend is exhausted as ***"short term volatility is greatest at turning points and diminishes as a trend becomes established. By the time all the participants have adjusted, the rules of the game will change again."*** Volatility is generated when investors without conviction cannot hold their position as the trend begins to change. The early adopters of a trend are the most knowledgeable and have the greatest time horizon, so they are able to hold through the normal ups and downs that occur in the markets. As the trend matures, the latecomers, who are simply chasing the past performance, have little conviction in the trend and can be easily shaken out when the original investors begin to take profits and move on. That high level of volatility is indeed a telltale sign of turning points (both up and down) in the investment markets. One of the biggest reasons for that is that the bulk of the investment capital is controlled by large institutions and Soros describes the problem very well in saying ***"the trouble with institutional investors is that their performance is usually measured relative to their peer group and not by an absolute yardstick. This makes them trend followers by definition."*** That trend following behavior exacerbates the reflexive process and leads to higher highs and lower lows, resulting in lower overall returns for the average investor and institutions as a group, but also leads to truly outstanding returns for investors like Soros who understand Reflexivity and have the discipline to take the other side of these short-term investors' movements.

The final lesson from Soros is quite similar to the lesson we wrote about a couple quarters ago in *#NotDifferentThisTime* on the wisdom of Sir John Templeton who said that investors would always ask him where is the best place to invest and he would respond to them that this was exactly the wrong question and that they should rather be asking where is it the most miserable? Investing where things are good and comfortable will consistently yield mediocre returns; not bad returns, just not great returns. I have often said that if you make in investment and you feel OK, you will make OK returns, if you feel good, you will likely lose money, and if you felt a little queasy, you will likely make money. Soros says it a little bit differently in that ***"the worse a situation becomes, the less it takes to turn it around, and the bigger the upside."*** His view is perfectly aligned with Sir John, or with Arjun Divecha at GMO who says *"you make the most money when things go from truly awful to merely bad."* Soros' point is that once things get really bad and the reflexive process has driven the trend to the extreme, the slightest change in perception can turn the tide and the bigger the move will be on the other side. George does add a couple qualifiers here in saying that ***"unfortunately, the more complex the system, the***

greater the room for error. The hardest thing to judge is what level of risk is safe." The markets are huge complex adaptive systems (that tend toward extremes of disequilibrium thanks to Reflexivity) and the complexity has been rising at an ever-increasing pace with globalization, financialization, securitization, Central Bank intervention and the increase in speed of everything from information dissemination to trading. Higher complexity means greater risk of errors and higher costs for those errors, so the most challenging thing to determine, according to Soros, is what level of risk is appropriate for investors to take. What these final thoughts seem to say quite loudly is that in an increasingly complex investment world, risk management and mitigation are paramount, that the ability to admit when you are wrong on a position and exit with a small loss is critical, that the necessity to maintain focus in areas of strength and expertise and not stray into unfamiliar territory is crucial and that understanding how the construct of Reflexivity can help us structure positions more effectively to capitalize on investment trends and take advantage of market dislocations. We believe that heeding the lessons highlighted above can help all of us spend more time enjoying the "virtuous" and less time being punished by the "vicious".

Fourth Quarter Review

In the Third Quarter Review we quoted a line from the Second Quarter Review that talked about an emerging cyclical phenomenon that had developed in U.S. equity markets and said *"there has been a very interesting pattern in each of the past four quarters, that equity markets fall for the first two to four weeks of the period and then turn sharply upwards when the Central Doctors (Bankers) agree to provide another hit of Monetary Morphine."* Q3 made the pattern five in a row and as Q4 started, equities found themselves again in a fairly steep (well, steep by QE Regime standards) decline that the myriad "Top Callers" were triumphantly announcing was triggered by the IPO of Alibaba in mid-September (calling the huge demand for BABA shares an obvious sign of speculative excess). The next few weeks were indeed ugly for equity investors as the S&P 500 plunged from 2011 on 9/18 to 1862 on 10/15 (a swift (7.4%) drop) and the first two weeks of the quarter were down yet again (5.6%) and in need of another shot of stimulants. Unfortunately, Doctor Bernanke was seemingly on vacation, so hospital administration sent in the physician's assistant, Doctor Bullard, to try and calm the patient. With no actual syringe in hand, Dr. B just started talking about how there was plenty of monetary morphine left in the store room and that he was sure that Dr. Yellen would be quick to inject any and all comers next year if conditions had not improved, as soon as she was given her white coat. The placebo effect took over immediately (although usually the patient actually has to ingest the actual placebo for effect to work…) and markets ripped higher for the balance of the quarter (as they are supposed to do in year three of the Presidential Cycle where the average Q4 return is 8%) and the pattern was completed for the sixth time. This surge was similar to something we discussed last quarter that there was *"another statistic that is interesting is that in every mid-term election year since WW II the equity market return from the last week of October through year-end has been positive, and further, has averaged nearly 9%."* The move in 2014 started a week early, but from the turn on 10/16, equity markets were up 10.6%.

We were writing the Q3 letter right in the midst of this turnaround and reminded readers of what we wrote in January that "*historically every $100 billion of QE has translated into 40 S&P 500 points (calculated by Larry Jeddeloh at TIS) yielding a year-end 2014 value for the S&P 500 of 2,058 ($500 B of QE = 200 points on top of starting level of 1,848) which turns into an 11% price return for the index for the year. Through the end of Q3, the S&P 500 was up 8.3%, actually precisely where it should be if that 11% return was the right number.*" We discussed how a 2,058 S&P level left a little upside for the last two months of the year and equity markets followed the script nearly perfectly for the balance of the year as the S&P 500 did indeed continue to rally in November and December and finished the year at 2,059, almost right on the TIS equation estimate (a little bit of luck to be that close). The price return came in right on the estimate, up 11.4%, and with another 2.3% from dividends, the total return for 2014 was a solid 13.7%. While not quite as robust as 2013's stunning 32.4% return, the S&P 500 bested all the pundits' forecasts (again) in predicting 8% to 10% returns. It turned out that the historical trend we wrote about last quarter proved true in *"that there have been 17 years where the S&P 500 has returned more than 25% and the average return in the following year has been just 6%. The range of outcomes is quite interesting, however, as 6 of the years were negative and 6 of the years produced double-digit returns again, with the remaining 5 years closer to the average. At the beginning of Q2 it appeared the 6% number was highly likely and as we sit here today at the end of October, the upper end of the range looks possible."* In talking about how the balance of 2014 might play out, we talked about how the more important question in our mind was that *"if the markets have been driven by the QE equation since 2009, as Larry suggests, the cessation of QE this month does beg the question of what happens in 2015?"* We said we would leave that question to the Market Outlook section and we laid out some concerns about the downside risks to U.S. equities if the patient was forced to look at the MRI (valuation measures) without the soothing effect of the monetary morphine. Just to reiterate here, when looking at valuations in the U.S. equity markets, it is hard to ignore the picture on the screen, that on every measure, markets are meaningfully overvalued, whether you look at Yield, P/B, Market Cap/GDP, CAPE Ratio, Tobins Q or P/E Ratio. We said that all of these were mile markers along the highway to the danger zone and most of them are now flashing brightly.

But back to the performance in Q4 which was uniformly strong in U.S. equities and had many of the characteristics of a healthy bull market with Small beating Large, Growth beating Value and the U.S. trumping International and Emerging Markets as King Dollar took its toll on investors in overseas markets where currency returns were a significant drag for U.S. investors. That said, there were a few anomalies that left us scratching our collective head; long bonds crushed stocks, rising another 8.6% in Q4 (to complete a truly spectacular return of 25.1% for the year, more on that in bonds section below), yield products were mixed as REITs surged, up a stunning 14.4% (to complete an even more stunning 30.3% year, more on that below) while MLPs got crushed along with oil, plunging (12.3%), (giving back most of their gains for the year, up 4.8%) and the top four performing sectors in the S&P 500 were Utilities, up an amazing 13.2% (up a more amazing 29% for the year), Healthcare, up a healthy 7.5% (up an even more healthy 25.3% for the year), Consumer Staples, up a robust 8.2% (up an equally robust 16% for the year) and Technology, up a solid 5.2% (up an even more solid 20.1% for the year), the anomaly here being that these are not the sectors that normally lead in robust economic expansions (Kiril Sokoloff of 13d says that these types of anomalies have incredible information content, so we will explore what this performance might be signaling). Given markets are leading indicators, perhaps the strong performance of the defensive sectors is telling us that the economy is not quite as strong as the media would lead us to believe. In fact, the first estimate of Q4 GDP came in at 2.6%, well below the estimated 3%. Adding the four quarters of 2014 together at -2.1%, 4.5%, 5.0% and 2.6%, we get U.S. Real GDP expanding at 2.5%, well below the 3% that the Fed (and everyone else) predicted (again). Moreover, the number is being "bailed out" by an unusually low PCE Deflator (some would say manipulated…) that boosts the real number. The reality is that we have never had Nominal GDP growth this low without being in Recession. Time will tell if it is different this time or whether an NBER (the group that decides when Recessions start/end) proclamation looms on the horizon.

In thinking about slowing GDP growth and a potential change in the broad economic environment, we wrote last quarter that *"another potentially worrisome sign of potential economic malaise is the rapid decline of oil prices, which dropped a stunning (14%) during the quarter, calling to mind comparisons to the dramatic declines in 2008 right before the Global Financial Crisis."* Q4, believe it or not, was actually worse for oil (and other commodities as well) as black gold slumped a mind numbing (41%) bringing the full year loss to (43%). Looking at the peak to trough drawdown from mid-June to the end of the year, WTI Crude fell from $107.26 to $53.27, a jaw-dropping (50.3%) swoon. The price decline didn't stop with the calendar, however, and oil dropped another (9.4%) in January. Amazingly, oil would have actually been down (16.6%), but a huge 8.6% short squeeze rally on the last day of the month caused by GSCI rebalancing the Index (had to buy more since oil had fallen so much) pared the loss back to single digits, leaving the new peak to trough decline at (55%). Perhaps the most worrisome part of the oil story is that the current price decline is the result of a supply shock as the Saudis did not follow their normal protocol to trim production to keep the global market in balance as new supply came on-line from U.S. Shale, Libya and Iraq. There are all kinds of theories as to why the Saudis decided not to curtail production, from a desire to punish Russia and Iran, to a desire to wipe out the U.S. Shale producers since total U.S. production exceeded a level established by an agreement from 1971 when the U.S. moved from the Gold Standard to the Oil Standard (moved away from gold backing the Dollar to oil backing the Dollar). Whatever the reason, the real problem was the massive speculative long positions in the oil futures markets that began to accrue meaningful losses and had to be quickly unwound as the price began to cascade downwards. The development of the oil futures markets over the years has been a boon to producers who can more effectively hedge their production, but these markets have attracted ever increasing volumes of speculative investment capital as well and when the number of "paper barrels" reaches an extreme as it did in 2008, and again this past year, it only takes a little change in momentum to trigger large liquidations and rapid price declines. There have been lots of pundits, media personalities and oil executives calling a bottom in oil since the mid -70s (quite unsuccessfully, obviously, as we sit at $48…) and there is unanimity in the investment community that there will be a sharp bounce in oil prices this year. The logic is that every oil price drop since 1995 has been followed by a sharp rebound, but the flaw in the logic is that all of those declines were demand driven (economic growth slowing leading to less consumption) and we have to go all the way back to 1985 to see what happened during the last supply shock. We will cover this topic more in the Market Outlook, but suffice it to say here that it is worrisome that there is not one Wall Street analyst that has a year end forecast for WTI below $60 which means there is broad consensus on a rapid price recovery and we know the history of unanimous consensus over time is not good.

We talked in the last letter about how one of the biggest surprises of Q3 was the strength of the U.S. Dollar and that strength continued into Q4 as DXY rallied another 5%. Much of the rally of the Dollar could actually be explained not by the strength of the U.S. currency, but by the incredible weakness of the other global currencies, most notably the Yen and the Euro as the BOJ fired a huge bazooka in October by accelerating QQE and the Europeans inched ever closer to their own version of QE. One very interesting phenomenon that we wrote about was that *"as we have seen over and over with Super Mario Draghi, all he has to do is "say" he is going to do something and the markets "believe" him and we have seen historic moves in a number of assets in response to the ECB musings, including record low Sovereign bond yields and now near record movements in the Dollar, as the Greenback soared nearly 10% in September alone."* As we came into the New Year, it was time for Mr. Draghi to finally deliver the "whatever it takes" he had repeatedly promised and "show us the money" to get the ECB balance sheet growing again along with all the other developed market central banks. Expectations were very high for the big announcement on January 22nd and, as expected (or as leaked…), Mario's oration was extraordinary as he promised a coordinated European National Bank effort (still no monetary union authorizing the ECB to act unilaterally) to buy government bonds in an effort to curtail the developing deflation problem and stimulate growth in the European Union. The immediate reaction was quite positive and investors listened to the headlines (and perhaps not the details, like nothing happens until March, which leads one to question whether the Germans have fully agreed…), the Euro spiked downwards, European equities spiked upwards (particularly Germany, which benefits most from the relative weakness of the currency as the largest exporters) and the Dollar continued its parabolic rise. The complicating factor is that the positive reaction has faded in recent days as tremors from the Greek election (the radical leftist Syriza party won and is, so far, trying to play hardball with the Troika) were felt across the Continent and markets gave back a big chunk of their early gains. We will spend a lot of time monitoring this trend as getting the Dollar right in 2015 may be one the most important portfolio decisions an investor can make.

The ascent of King Dollar (coupled with the rapid decline in oil) punished International & Emerging Markets equities (other than China, more on that in separate section) and broad Commodity indices for the second consecutive quarter and losses were pervasive. To review the broad indices, the ACWI ex U.S. fell (3.9%), EAFE was down (3.6%), the MSCI EM Index dropped (4.5%) and the Bloomberg (formerly the DJ-UBS) Commodity Index was down a painful (12.1%). Looking more closely at the international equity markets the breadth of the negative returns can be seen as only five of the twenty-two developed markets in the MSCI database managed a positive return in Q4 and none of them achieved a return that beat the S&P 500. The damage was quite severe again in Europe as the Euro continued to slide and only Belgium and Ireland managed positive returns, up 0.6% and 1.9%, respectively. Looking back at this section from last quarter's letter, there is a little bit of déjà vu (the bad kind) as the numbers were ugly then, and were ugly again to end 2014. We wrote that "*the Euro got smacked by the Dollar and losses were large across the Continent with Germany dropping (11.2%), France down (8.4%), Spain down (8.6%), Italy falling (8.7%) and two countries with some banking woes, Austria and Portugal plunging (21.6%) and (25%), respectively. Three of the European Emerging Markets, Russia, Turkey and Greece were pounded hard, losing (15.4%), (11.8%) and (20%), respectively.*" In Q4, the numbers were similarly bad (with the exceptions of Germany and Turkey) as Germany was down (0.4%), France fell (6.1%), Spain dropped (8.2%), Italy tanked (13.4%), Austria fell (7.3%), Portugal plunged another (23%), Russia cratered (32.9%), Turkey escaped the bloodletting, rising 11.6% and Greece collapsed another (28.8%). One country we didn't discuss in Q3, which is worth highlighting here, is Norway, which traded like an Emerging Market in Q4, shedding one quarter of its market capitalization, down (25%), as the plunge in crude prices hit commodity related countries very hard. There are likely to be a few babies thrown out in that Norwegian bath water, so we will likely be doing some extra diligence on the Nordic markets in the New Year.

One of our favorite developed markets over the past two years has been Japan and there was a great deal of excitement in the Land of the Rising Sun in Q4. The dynamic duo of Abenomics, Prime Minister Abe and BOJ Governor Kuroda, decided that a moribund first half of the year in the equity and Japanese currency markets was not what they had in mind when crafting their three step (or, more precisely, Three Arrow) program, so it was time for some dramatic moves. We wrote about their big Halloween Treat last quarter *"then in mid-October, the Yen began to weaken and equities began a very sharp rally culminating in the Shock and Awe surprise announcement by the BOJ on Halloween morning that they would indeed "Do Whatever It Takes" in extending QQE and the Yen collapsed from 109 to 112 in a heartbeat and the Nikkei surged nearly 5% for the day (and lucky owners of DXJ, like us, made 6.6%) to close a wildly volatile month."* In a world addicted to stimulants, this massive injection of monetary morphine was just what the doctor ordered and Japanese markets rallied strongly to finish the year with the Nikkei 225 up 8% in Q4 (up 10% for the year) in Yen terms. U.S. investors didn't capture that gain unless they hedged (which we did and will continue to do) as the USDJPY cross rose 10% for the quarter (up 14% for the year) as Kuroda-san hit the bulls eye with his bazooka and kept the Yen on its descent path (which we believe will continue for years to come). The biggest beneficiaries of Abenomics are the exporters, which showed significant strength in Q4 with Toyota up 7%, Sony up 14% and Fuji Heavy (who make Subarus which have become the official car of the People's Republic of Chapel Hill) up 19% (and a stunning 45% for the year). Years of cost cutting as a means of survival in a strong currency regime has made Japan Inc. incredibly lean and the high degree of operating leverage in these companies means that even small moves downward in the Yen result in large moves up in profits (and stock prices). Everything wasn't great in the Japan equity markets, however, as the other traditional beneficiary of a lower currency, the banks, ignored the conventional wisdom and continued to plumb lower levels. Using Mitsubishi UFJ (MTU) as the analog, Japan's largest bank should be benefitting from a clean balance sheet, rising NIMs and a weaken Yen, yet MTU fell (2%) during Q4 and was down (17%) for the year. The problem appears to be that despite rising inflation, the deeply ingrained fear of deflation continues to depress the demand for credit and the Japanese banks just can't seem to get out of neutral. Like a coiled spring, these assets are becoming incredibly cheap, but we have been wrong in thinking that investors would seek out these undervalued assets and push prices higher. The continued weakness of the Yen will drive equity prices higher (and we believe will eventually accrue to the banks too) and we wrote last quarter that *"we are reminded that the last time the BOJ made an announcement like this, the Yen dropped 25% and Japanese equities surged 60% over the next twelve months and while the conditions are not exactly the same as in late 2012, we do sense a similar commitment by Abe-san and Kuroda-san to show the world that work of Abenomics is far from complete."* In the past three months we have traveled about 15% down the path, as the Yen has weakened 4% and Japanese equities are up 8% (in Yen, so the key is to remain hedged) versus a zero return for the S&P 500, so we reiterate our belief that Japan will outperform the U.S. going forward and that our theme of The Abe -san Also Rises will continue to be a story of Japanese equities running with the Bulls (a play on *The Sun Also Rises*, a Hemingway novel about a group of friends who travel to Spain to run with the bulls).

We wrote in the Market Outlook last quarter *"we favor Emerging Markets relative to developed markets despite the pervasive fears of the end of QE in the U.S. and Dollar strength causing stress for EM. That said, there are clearly certain countries that will suffer more than others if the Dollar continues to remain strong, so we will dig deeper into how we would segment EM into Service (current account surplus) economies and Commodity (current account deficit) economies."* If we look at Emerging and Frontier Markets, Q4 was not much fun for investors, as our short term fears were realized, King Dollar and crashing oil prices conspired against most developing markets and it was a sea of red on the performance tables. There were two markets that managed to produce strong returns, one that was expected (China) and one that was totally unexpected (Turkey). We will come back to those below, but first, digging beneath the Index numbers (MSCI EM down (4.5%) for the quarter and (2.2%) for 2014 and MSCI FM down (12.5%) for Q4, but up 6.8% for 2014) we see some very disparate results as the Commodity Countries were hammered, Russia down (32.9%), Brazil down (14.9%), Mexico down (12.3%), UAE down (21.6%), Qatar down (8.9%), Nigeria down (26%), Argentina down (8.1%), Saudi down (24.2%) and Kuwait down (13.7%). Like in the Norway case we described above, we think there were a lot of babies thrown out with the oily bath water in Q4 as investors sold everything in these countries despite the fact that many of the companies have very little to do with oil and, in some cases, will not be impacted by oil price declines because the governments own the bulk of the natural resources and they have committed to funding the social programs (this is primarily true in the Middle East, but could also apply in some ways to Russia and Brazil) which will be paid to citizens regardless of the price of the commodity. We would expect to see some very strong returns in select companies in these markets that focus on the rising middle class consumer and we would expect to find some real gems picking through the rubble in the coming months (to completely mix the metaphors). Another thing to keep in mind in 2015 is something we wrote about in Q3, that *"the opening of the Saudi market to foreign investors should serve as a significant catalyst to move the market higher as capital flowing in from global institutional managers is likely to equate to a significant portion of the current Saudi market cap. Additionally, "opening" the market removes the primary hurdle that has historically prevented MSCI from including Saudi in their Indexes."* If MSCI makes the Index move in 2015, look for the Saudi markets to be very strong.

As we anticipated, the Services countries were more resilient in Q4 and while overall EM/FM returns were relatively poor, a number of countries generated solid returns for the quarter (and full year 2014) including Indonesia, up 0.6% for Q4 and 26.6% for 2014, Philippines, up 0.7% in Q4 and 25.6% for 2014 and Kenya (home of the Silicon Savannah), up 1.8% for Q4 and 23.4% for 2014. Kenya is a great example of a market where innovation and rapid technology adoption in mobile payments (90% of Kenyans use mobile payments) has created an economic boom that is likely to persist for decades to come. India (one of our favorite markets for 2014, and 2015 too) took a pause that refreshes in Q4, falling (0.7%), but had a very strong year, up 23.9% on the heels of the momentous Modi victory and the emergence of Modinomics that should pave the way (literally pave the way as one of major commitments is to build a huge road network to expand commerce) for future returns. The potent combination of Rajan as RBI Governor and Modi as PM bodes well for investors in India for many years to come. We discussed last quarter that investing in companies that help expand infrastructure, like banks, real estate developers and cyclicals, would benefit from the reform agenda in India. Over the past three months there were a number of winners like ICICI Bank, up 7%, State Bank of India, up 16% and DLF RE, up 37%, and a few losers like Coal India, down (2%) and Tata Steel, down (20%). As mentioned above, one of the biggest surprises in EM was the performance of Turkey which overcame huge current account problems, a near currency collapse and the antics of a renegade President to produce a very strong 11.6% return in Q4 and an equally appealing 18.7% return for the year. Turkey was one of the Fragile Five (Brazil, India, Indonesia, South Africa, Turkey) that was supposed to be killed by the Taper and end of QE in the U.S.; however, no one sent the cease and desist memo to those countries as four out of the five produced solid returns in Q4 and 2014 and Brazil only struggled in Q4 after the disappointment of the Dilma reelection and the oil price collapse. Korea was the other big surprise in EM (although it is still hard for us to consider Korea an emerging market) as the weak Yen hurt their relative export attractiveness and Apple ate Samsung's lunch in Q4 (Samsung is a huge percentage of the Korea index) so Korea shed (7.9%) for Q4 and was down (11.1%) for the year. If the Korean government can respond with some measures to weaken the Won, Korea could be a surprise winner in 2015 as expectations and prices are low and growth is solid.

China has been one of the most interesting and challenging markets of the past year as there is a never ending stream of analysis, speculation and prediction about China in the media and we wrote last quarter that *"China was very challenging for the first half of the year as the indices made no progress, but as we have said to focus on specific sectors in Internet, Healthcare, Retail, Consumer and Alternative Energy, there have been some real winners in those segments."* The second half of the year, and Q4 in particular, was a completely different story as broad markets in China surged 7.2% for the three months and the A-Share market in China was the best performing market in the world, up a staggering 53.9%. The combination of the Third Plenum Reform agenda beginning to be implemented, SOE reform, a change in position by the PBoC on liquidity (moved from tightening to loosening) and what appears to be a concerted effort by the new Leadership to shift assets from the property market to the equity market resulted in some spectacular performance in Chinese equities. We commented last quarter that *"we believe that the Chinese equity markets are on the verge of a significant breakout as the government implements the Through Train (connection between Shanghai and Hong Kong markets) and we have been increasing our exposure to the A-Share market to capitalize on the increased investment activity that will result from this expansion of market access."* Looking back, we were right on the direction of the move, but completely missed the potential magnitude, and while the incremental exposure we added was accretive, we were too conservative in our timing. A lesson to take away from Q4 was that when China finally does move on one of their Reform agenda items the response is swift and the momentum builds quickly. A huge miss on our part was to not make the second order thinking leap (perhaps one of the most important skills in investing is anticipating the secondary impacts of primary movements) to build an overweight position in the Chinese brokerage stocks as they clearly were going to be the beneficiaries of the ramp in investment activity resulting from the Through Train Program. To illustrate, CAF (the A-Shares closed end fund) was up 25% in Q4, ASHR (the A-Shares ETF) was up 35%, but CITIC Securities (cn:600030) and China Merchants Securities (cn:600999) were up a stunning 155% and 143%, respectively. Another area we discussed last quarter was that we had been early (sometimes the euphemism for wrong) in thinking about *"a number of investment ideas that we thought would benefit from the Reform Agenda and the move toward a more Consumption based economy, including China Coal Energy, Great Wall Motor Co., China Vanke, China Overseas Land, China Resources Land and Poly Property Group (CN:601898, HK:2333, CN:000002, HK:688, HK:1109, HK:119, respectively) and a basket of China Banks"* and Q4 confirmed the early, rather than the wrong, as these companies surged 48%, 47%, 38%, 15%, 28%, 15% and 60%, respectively. There will clearly be some consolidation in these markets in the early part of 2015, but we believe that we have entered a new Bull Market in China and there are outstanding returns available for investors who are willing to ignore the "Noise" in the media about the slowing economic growth (quality of growth is more important than quantity) and focus on the "Signal" that the world's second largest economy is in the beginning stages of a historic transition toward consumption and away from fixed asset investment.

Turning to Bonds, it was another unexpected outcome; unexpected, that is, if you were in the consensus camp that believed all year that rates would rise and bonds returns would be poor. We described the posture of fixed income investors last quarter when we said *"with the end of QE in the U.S. this October and the threat of the Fed raising rates sometime in 2015, Fixed Income investors are feeling like they have a MiG on their tail with missile lock on, and are clenched and waiting for the missile to head their way."* This description came from one of the opening scenes of Top Gun where the MiG pilot menaced Cougar, but never shot, and we went on to discuss how the Fed has been menacing bond investors for years with the constant threat of higher rates only to do nothing quarter after quarter. We talked about one of my favorite charts, a sequential quarterly graph of the forward yield curve since 2009 showing a series of steep upward sloping lines between cash and two-year Treasury notes (implying imminent rate increases) and talked about how this chart *"shows how the Fed has kept their finger off the trigger and maintained Fed Funds near zero (ZIRP, Zero Interest Rate Policy) despite the markets "knowing" that they would raise sometime "next year."* As Mark Twain reminds us, "It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so…" and the Bond Bears were licking their wounds again in Q4 as they clung to what they knew for sure (rates would rise) and stayed short into the teeth of a 1.8% increase in the Barclays Aggregate Index and a stunning 8.6% increase in the Barclays Long Government Bond Index (bringing the full year return to an equally stunning 25%, nearly double the return of equities). In last quarter's letter we voiced a Variant Perception on interest rates (and therefore bonds) and talked about how *"the impending end of QE this month implied (at least to us) that interest rates were more likely to fall, than rise, and that government bonds would continue to be a surprisingly good investment."* Three months later, despite all the Fed jawboning, the newly created Fed Dots indicator, and the seemingly endless stream of hawkish Fed Minutes, rates continued downward and long Treasuries turned out to be one of the best performing assets in Q4 and 2014 (which we actually said would be the case last December).

Expanding our view beyond Treasuries, other types of fixed income investments had a much rougher Q4 as credit troubles took their toll on high yield bonds and currency losses took their toll on global and emerging markets bonds. In the high yield market the overall index masks some of the real damage done to bondholders in the riskiest segments of the markets and bonds in the energy sector were severely punished with the collapse in oil prices. The BoAML High Yield Index was down (1.5%) for the quarter, which trimmed full year returns to 2.5%, but the CCC sub-index fell (3.3%) in December alone and finished down (2.6%) for the year. Returns in the high yield market were the worst since 2008, which of course correlates with the massive inflow into the HY market at the beginning of the year as investors desperate for yield kept stretching ever further out on the risk curve (investors always buy what they wish they would have bought…). The losses in the energy segment of the market were quite large, down (15%) in recent months, with many bonds trading down into the 70s and some of the worst credits hitting the 20s and 30s. There is a lot of concern that some large percentage of the massive $550 billion of debt issued by energy companies during the Shale Boom will default as oil prices have halved, but we expect that only a small percentage of issuers will go bust as many operators have done a good job hedging production and have bought themselves time to cut costs and restructure. One segment that is particularly vulnerable are the energy services companies as the E&P companies cuts in cap-ex are a cost reduction, but are a revenue reduction for service companies. We expect to see some tremendous opportunities to buy fantastic assets at fire-sale prices in the coming months and we will talk more about the opportunity (and the potential to raise an investment vehicle to take advantage of these opportunities) in the Market Outlook section. Around the globe, government bonds continued to hit new lows in rates seemingly every day and the rising prices of those bonds should have accrued to solid returns to investors. However, King Dollar levied a large "tax" on U.S. based investors and the Barclays Global Bond Index fell (1%) in Q4 and managed only a 0.6% return for the year, a very disappointing outcome given the dramatic fall in interest rates from Germany to Japan and across all the peripheral European markets (aside from Greece). Emerging Markets were the one safe haven (ironic) in bond land during 2014 as investors judged the higher growth rates in these regions more likely to support corporate cash flows to service debt. The JPM EM Bond Index was hit by King Dollar in Q4, falling (1.9%), but for the full year, EM debt was up a very solid 5.5%. One common characteristic of global bond markets is that the risks of inflation hurting bond returns continues to be very low and, as we have discussed over the last few quarters, maintaining a Variant Perception on longer duration fixed income should continue to be very profitable as global interest rates in the developed world are likely to remain under pressure from the Killer Ds of Demographics, Deflation and Debt. We will reiterate what we said last quarter that *"we know two awfully good fighter pilots who espouse that strategy today, Van "Treasure" Hoisington (who only owns long treasuries) and Russell "Horseman" Clark (who owns large positions in long-duration Bonds and Bunds), who would both say that they are staying with the Wingman Formation for the foreseeable future. We continue to side with Treasure and Horseman and think that rates will be "Lower for Longer" (expect that long bonds will outperform again in 2015).*

The fourth quarter was about as divergent a period for yield investments as we have ever seen with investors clamoring for REITs no matter how high the price rose and shunning MLPs no matter how low the price fell. Sensible long-term investment strategy dictates that an investor would be better off selling assets at premium prices and buying assets as bargain basement prices, but in Q4 investors decided that these opposing trends were going to persist for some time. The S&P REIT Index surged an astonishing 13.7% for the quarter to cap an equally astonishing 30.2% return for the year (perhaps most astonishing is that this is the third year in the last six where REIT index returns have been around 30%, with 25.0% in 2009 and 31.7% in 2010) as a 3.6% yield secured by trophy RE proved irresistible to investors in the ZIRP world of 2% ten-year treasuries. In stark contrast to the mad dash for real estate, investors scrambled to sell MLPs as fast as they were able and drove the Alerian MLP Index down a remarkable (12.3%) in Q4. Recall that the big drop occurred right after investors scrambled to get into MLPs at any price the previous nine months, driving the AMLP Index up 19.5% through September and the big turnaround left MLPs up an uninspiring 4.8% for the year.

We wrote last quarter that Q3 was *"an absolutely miserable time to be a commodity investor as the huge surge in the Dollar in late August and September crushed all things related to commodities"* and it turns out that Q4 was not nearly as miserable with the oil complex getting completely decimated, metals taking another small hit and the lone bright spot being the Ags which managed some nice gains (before giving most of them back in the New Year). Looking more closely at the individual markets, some of the numbers are really astonishingly bad. The precious metals were not too terrible, with Gold down only (2%) and Silver down (7%). The declines in energy prices were epic, with Oil completely collapsing, down (41%) and Natural Gas plunging (28%) as the liquidation of long futures contracts accelerated in the wake of the decision by Saudi Arabia on Thanksgiving Day to not cut production and there were clearly some big "taps on the shoulder" (prompt to sell positions to meet margin calls) to overleveraged traders who had bet that the Saudis would arrest the decline by taking one for the OPEC team and bring supply back in line with demand. At present there is about a 1.5mm barrel/day imbalance in the oil markets, which has turned the oil futures curve into very steep contango (upward sloping, where the current month trades at a discount to the out months, causing meaningful negative roll-yield losses for commodity index owners). The contango is so steep that investors are buying huge amounts of crude today and storing it in VLCC (very large crude carrier) ships to store it for a period of time in anticipation that the pries will rise in the future and the higher process will offset the rental costs of the ships. There are estimates that between 40mm and 50mm barrels of oil are being stored on the water today, which we have not seen since right after the dramatic drop in prices in 2009. How low can oil prices fall? There are a plethora of bottom callers (many who have been calling the bottom since $75 last fall) who are in direct opposition to the growing number of "experts" who are predicting that prices could fall as low as $20. We will discuss the oil markets in detail in the Market Outlook section, and after the Dollar, this might be the second most important decision that investors will face in 2015. After a horrendous Q3, the Ags surged in Q4 as Wheat jumped 20%, Soybeans rose 10% and Corn surged 18%. In November, we wondered aloud (so to speak) that "*As we sit here today, the words of Sir John Templeton are running through our minds over and over to look for opportunities where things are the most miserable and on the TMI Scale (Templeton Misery Index) commodities look pretty interesting since the world is convinced that the Dollar is going to surge and that the Commodity Super Cycle is over. Conventional wisdom in investing is a very strong contrarian indicator, so we may find ourselves writing about better returns in these sectors in the quarters ahead."* So far, the score is conventional wisdom one, TMI zero, but it is a long year and we still believe that there are too many investors on the same side of the S.S. KingDollar which means we will likely be writing about commodities more than normal this year.

2014 turned out to be a very challenging year for Hedge Funds and Q4 was no exception to that trend as busted merger arbitrage deals, dramatic moves in commodities, the return of volatility and another year where the most heavily shorted equities actually outperformed, led to mediocre returns across the hedge fund landscape. In Q4, event driven strategies suffered the most as a number of merger deals broke and the HFRX Event Driven Index produced negative returns, falling (5.5%) to finish the year in the red, down (4.1%). On the other side of the spectrum, the huge moves in commodities actually lasted long enough (for the first time in four years) for the trend followers to make some money and the HFRX Macro/CTA Index rose 2.6% to manage a positive 5.2% for the year. Missing from the average returns of the systematic strategies is the fact that the CTAs as a group rode the big moves in commodities in Q4 to some much stronger than average returns and the CISDM CTA Index was up a more robust 15.1%. Digging even a little deeper, within the broad dispersion of the CTA group, was a handful of funds that generated 50% to 70% returns with concentrated bets on commodities. The HFRX Equity Hedge Index struggled again in Q4, eking out only a 0.2% gain, to bring 2014 returns to a very sub-par 1.4%, as negative alpha on the short side continued to plague long/short managers. Buried in the breadth of this segment were some really poor returns and some truly outstanding returns by managers focused on China and Healthcare. In fact, nine of the top ten performing long/short funds were healthcare related that rode the powerful moves in biotech to produce 30% to 50% returns for the year. The ZIRP environment continues to challenge market neutral managers (hard to make money with cash returns at 0%) and the HFRX Relative Value Index actually lost (3.1%) to deliver a very disappointing (3.1%) loss for the year. For the first time in many years, hedge fund returns lagged even traditional fixed income markets, which rose 6%. That said, we still see significant benefit in shifting from Bonds toward Absolute Return strategies given their positive correlation to interest rates (they have a floating rate profile given short proceeds sit in cash) where Bonds have negative correlation (rates rise, bonds lose money) in an environment where the potential for rising rates could wipe out fixed income gains quickly. One “hedge fund” strategy (in quotes because not much hedging, but charge HF fees) that produced solid returns on average (above the ACWI) was home to a few top performing hedge funds of 2014, Activism. The HFRX Activist Index was up 5.5% in Q4 and 8.5% for the year. Concentrated bets on a couple of high profile names like AAPL, VRX and HLF helped propel the like of Icahn and Ackman to 30%+ returns.

Back in January we took some liberties with the Chinese zodiac and renamed the Year of the Horse, the Year of the Alligator, as we believed that many markets have moved to extremes (alligator jaws open) in 2013 and were due for a snap back (alligator jaws close) in 2014. We expected the big winners in 2013, developed markets equities (Japan, US, Europe) and small cap equities to face headwinds while the big losers of 2013, emerging markets, gold miners, gold and long bonds would have tailwinds in the New Year. The early results were encouraging as the alligator jaws began to snap shut quickly in 2014 as anything related to safety surged and equities struggled in the first half of the year. As the year progressed, however, the results became more missed as commodities tumbled in the second half of the year as the King Dollar theme emerged, emerging markets gave back much of their early gains and large cap U.S. equities finally caught a bid late in Q4 to finish strongly. The one alligator jaw that performed precisely as expected was the long bond vs. S&P 500 jaws as they closed nicely and reversed over the course of the year with long Treasuries delivering nearly twice the return of equities. Japan struggled early and performed well in the closing stretch while Europe and small caps were laggards as expected and gold and gold miners were strong early and very weak late with miners falling significantly into the red in Q4. Overall, there was a lot of jaw snapping going on in 2014 and it was difficult for most investors to make a lot of money. There were some great performances and there were returns to be had in places like India, China, Biotech, Long Bonds on the long side and shorting commodities produced some outstanding returns for the CTAs and a handful of energy traders and fundamental long/short managers who stepped up to short oil when the majority were calling for a bottom in the fall. As 2014 came to a close, we increased our focus on the theme of our Q3 letter, *Highway to the Danger Zone,* and prepared for the turbulence that we saw on the horizon. Last year was about dodging Alligators; 2015 may be more about combat and the words of Viper’s admonition to Maverick’s class at Top Gun, “there are no points for second place.”

Market Outlook

Let's take a quick look back in order to provide some foundation for looking forward into the New Year. One of the things we discussed in *Highway to the Danger Zone* was how *"we dubbed 2014 the Year of the Alligator when we did our first Around the World Webinar in January and we had six key regional investment themes where we thought it would be (to quote Maverick), a Target Rich Environment."* Coming into 2014, we saw opportunities in Argentina, Spain, Greece, India, China and Japan, and taking a look at the scoreboard, those areas delivered solid results overall in the quarter, and for the full year, as Argentina, India and China (A-Shares) soared, Japan was solid, Spain was hit by the falling Euro and Greece was pummeled in Q4 as fears of the leftist Syriza party winning the election grew stronger. As the year progressed, we dove deeper into a number of areas where we saw compelling target opportunities and listed a number of those specific ideas in last quarter's Market Outlook. Looking at the last three months, before we dive into our view for the rest of 2015, it is clear that heightened volatility created many winners and losers and investors had to be nimble and tactical to capture excess returns in 2014. As we discussed in the Q4 Review section above, it was a tumultuous year where many markets were flat, there were a few that produced huge returns (like A-Shares and India) and much of the returns for the few markets that produced returns were earned in the last eight to ten weeks of the year (e.g. 11% of the 13.7% in the S&P 500 return came after 10/15). So let's take a peek at how some of the best ideas from last quarter performed and see where we stand today.

We discussed a quote from our summer ATWWY Webinar *When PIIGS Fly* that said *"should the ECB start expanding their balance sheet again, that will provide a brisk tailwind for European assets and the GIIPS countries in particular which are much more leveraged to the upside, as they are starting from a lower base."* We also mentioned how *"Europe as a whole has been officially left for dead as a recent Economist cover shows an obviously dead parrot with Frau-Nein Merkel standing next to it saying "it's only resting…"* Given the long-term track record of an inverse correlation between magazine covers and future performance, it made sense that perhaps Europe was due for a period of outperformance, yet we needed a catalyst. Looking at the basket of European ETFs for Germany, France, Portugal, Ireland, Italy, Greece and Spain, we saw mixed performance over the past three months with EWG up 7%, EWQ up 4%, PGAL down (13%), EIRL up 10%, EWI down (3%), GREK down (13%) and EWP down (9%). However, when we look at performance since the ECB announcement of a QE Program for Europe on January 22nd (the catalyst), we saw a different story with those markets up 5%, 4%, 1%, 7%, 3%, 10% and 2%, respectively, versus a rise of 2% for the S&P 500. We also pointed out that *"the CAPE ratios for these countries tell us that the returns over the next decade will be very strong, but the outlook for the next ten months is less clear given all the uncertainty related to government transitions, ECB policies and Euro membership jockeying. We are finding lots of cheap assets across a wide swath of the markets, but we are cognizant of the near-term risks, so will be cautious in our angle of ascent in the PIIGS allocation."* We have been cautious on building positions in Europe to date, but with Super Mario and Frau-Nein Merkel apparently on the same flight plan, we are now steepening the angle of approach and are beginning to build a meaningful overweight.

Back in the U.S., we talked about how it might be time to play a little defense, saying *"an interesting trade here would be to go long the high quality large caps (to "hide", if you really must have general U.S. exposure) and short the junky names against them, so long IWL and short IWM."* That defensive posture turned out to be good advice for a few weeks early in Q4, but then market momentum turned up on December 15th and the pair became pretty highly correlated and did not generate much return. Given our history of being "early" on our defense calls, perhaps this would not be a bad idea for the coming months, but much depends on global liquidity. We dove into some specific sectors, saying *"in healthcare, the biotech sector looked stretched again as IBB is now 8% higher than the February peak that preceded the (20%) correction in March and multiples seems bit extended after another huge run in 2014."* Caution was clearly not warranted here as the biotech sector continues to make new highs and IBB was up 9% vs. SPY only up 4% over the past three months. We said, *"the dispersion in technology has been quite dramatic as the old tech names like MSFT, INTC, ORCL and HPQ are up 30% while the new tech names like PCLN, EBAY, GOOGL, and NFLX are flat. There is an even wider dispersion between FB, up nearly 40%, and AMZN, down (20%), and we would expect to see some mean reversion in these segments in the next few quarters."* The Old/New Tech battle was more of a draw (slight edge to the New) with the Old Guard coming in down (7%), up 1%, up 12% and up 7%, while the New Guard was down (8%), up 7%, down (3%) and up 18%. However, the FB/AMZN battle played out quite nicely as a pair trade with FB up 1% and AMZN up 25%. We talked about how in *"financials, we continue to believe that the big banks have been "Dodd-Franked" and have been turned into utilities as they can no longer lever up to levels needed to generate big returns in a ZIRP world."* This view has been solid as the banks struggled with C down (4%), JPM down (1%), BAC down (3%), WFC up 4%, GS flat and MS up 5%. We talked about the consumer space saying, *"we came into the year thinking investors needed to "think outside the Big Box" as e-Commerce was going to make it tough on traditional retail. We think there will be continued pressure on these business models, but there are two short-term factors that may make these temporary longs, private equity bids and lower gas prices."* On cue, companies like BBY, BBBY, JCP and SHLD surged and PETM was actually taken out by a PE bid and they all rose smartly, up 15%, 16%, 6%, 9% and 15%, respectively. One industry within the consumer space we have loved since October of 2012 has been the Airlines. We mentioned last quarter how *"we liked the Airlines, but we also see continued strength in other travel related businesses like Car Rentals and Hotels."* We did an ATWWY Webinar titled *Consolidation = Upside* and continue to like industries where there is consolidation (airlines, car rentals, media, technology, energy, mobile, autos, defense). In the past three months, the airlines continue to generate strong returns, with AAL up 18%, DAL up 11%, UAL up 26%, LUV up 26%, and JBLU up 46% (and we think these numbers don't reflect huge boosts to EPS coming from lower oil prices in 2015). In car rentals, Hertz was up 5% and Avis was up 12% and in hotels, Starwood was up 3% and Hilton was up 13%. Finally, we noted that *"we expect continued strong growth in Defense as geopolitical tensions rise and countries like Japan and China increase military spending"* which has played out as expected with LMT up 4%, GD down (2%), BA up 20% and NOC up 21%.

Our positive stance on Japan played out well, as DXJ rose 6%, but our commentary that *"perhaps the most compelling opportunity, the banks (SMFG, MTU, MFG, Resona, Shinsei) have now bottomed and now have very significant upside (could rise as much as 60% to 100%) as their ROEs continue to recover and brokerage firms like Nomura and Daiwa should be very strong performers as domestic trading volumes increase and foreign capital returns to the Japanese market"* did not play out as expected at all. The banks continued to be challenged to put new loan money to work and the stocks struggled, down (12%), up 2%, down (6%), up 3% and down (8%), respectively, while the brokers were also mixed with NMR down (11%) and Daiwa up 4%. Our view on the Yen, however, continued to generate strong returns where we said *"finally, we reiterate the point we have discussed for many quarters now that "Japan has no choice but to pursue a weaker Yen"* and the Yen did indeed slip another (6%) for the past few months and we expect more weakness ahead (see Surprise #9 below).

Looking at Emerging Markets, we noted that it made sense to split countries into two groups, Service-based and Commodity-based, *"as the latter appear more* *vulnerable to the global growth slowdown and China's reduced appetite for commodities in particular."* This bifurcated posture worked very well in the past three months as countries like Russia, Brazil and Mexico struggled, falling (18%), (19%) and (14%), respectively, while countries like India, Taiwan and China rose 3%, 3% and 8%, respectively. Diving a little deeper, we talked about Russia, saying *"some of the cheapest assets on the planet exist in Russia today, in particular the Energy companies, the largest bank, and the primary Internet company. While it is hard to see when the negative Russia rhetoric will ebb, we are confident that long-term investors who buy these assets as these prices will make multiples of their money. A point to keep in mind is that most of the loss this year in these names has actually come from Ruble depreciation and we expect that trend is nearing its end."* We noted that it was likely that sectors related to energy (most people think Russia is just an energy play, where we believe it is also a consumer play) would struggle through mid-December (tax-loss selling finishes) and that there was a chance that things could turn more positive. Over the entire period of the last three months, the returns on Russian equities have been dreadful with Lukoil flat, Gazprom down (22%), Sberbank down (38%), Yandex down (40%) and the RSX ETF down (17%) as the RUBUSD collapsed (31%). However, since 12/15, Russian equities are a completely different story (a story we think extends throughout 2015, see Surprise #5 below) with those same names up 44%, 28%, 20%, down (4%) and up 30% and the RUBUSD firmer by 4%. We also highlighted Argentina, saying *"we have played in three equities, Macro Bank, Pampa Energia and YPF as we think the rewards outweigh the risks at present, so we will continue to scale into opportunities as they arise."* Performance for the services companies has been strong with BMA up 18% and PAM up 9%, but YPF struggled along with other oil-related names, falling (23%). In India, we wrote that *"investors will be rewarded for having exposure to industries and companies that help India grow to their full potential (Engineering, Construction, Electric Power), expand their middle class (Banking, Finance, Insurance) and help grow their consumption (Internet, Retail, e-Commerce)."* Performance was mixed over the period as some profit taking in December was reversed by strong performance in 2015 leaving names like EPI, TTM and IBN all up around 4%. Finally, we said that *"we believe the Chinese equity markets are on the verge of a significant breakout as the government implements the Through Train (connection between Shanghai and Hong Kong markets) and we have been increasing our exposure to the A-Share market to capitalize on the increased investment activity that will result from this expansion of market access."* The move in A-Shares was nothing short of spectacular in the past three months as ASHR surged 35% (actually was up in the low-40%s before some profit taking in January) and we expect that the Bull Market is just getting started in China (see Surprise #10 below).

We wrote fairly extensively last quarter about energy and discussed how the team had done a great deal of research on companies to come up with a "shopping list" of attractive names that we would want to own at certain price levels. We said that *"we see very significant upside potential in companies like EOG, FANG, CPE, WLL, PXD, RSPP and RICE as they execute on their development plans and commodity prices stabilize as supply and demand come back into balance."* So, as it turns out, we were perhaps overly influenced by all the bottom-callers in October (including some famous ones like T. Boone Pickens who said oil couldn't go below $75…) and we were a little early in thinking about words like "balance" in the oil market. The good news is that we were cautious about re-entering these markets and avoided the additional pain that occurred in Q4. Over the whole period, these names had mixed performance as the huge losses across the board through the end of tax-loss selling in mid-December have been reversed in a few cases. The tickers above were up 2%, up 7%, up 13%, down (37%), down (16%), up 17% and down (27%), respectively, as the recovery has been very "basin specific" (Permian and Eagle Ford doing well, Bakken and Marcellus not so much) as the market is paying very close attention to marginal costs given the uncertainty in the oil markets. We also discussed how there was another way to play energy in saying *"we also continue to see opportunity in the GPs of MLPs like ETE and PAGP, which have a preferred claim on the operating cash flows of the pipeline assets."* Despite lower prices, U.S. production will rise in 2015 and all those hydrocarbons have to be transported, so pipelines will benefit. Given the turmoil in the energy space, investors seem to still be missing the difference between these companies and the E&P companies, so ETE was only up 2% over the past three months and PAGP was down (3%), so the opportunity here is likely still quite robust.

We dug into the energy services companies and noted that *"companies like HAL, SLB and BHI help companies drill more wells to maintain production levels and hold leases (you must drill within a certain amount of time in order to maintain lease on acreage) and we particularly like the unit economics of the sand companies HCLP, SLCA, FMSA and EMES."* What we missed here was that as prices fell the E&P companies would put pressure on the prices charged by services companies and margins would be squeezed. These companies took some significant pain over the past three months with HAL down (20%), SLB down (10%), BHI up 22% (being taken over by HAL), while the sand names fell (12%), (33%), (49%) and (38%), respectively. The only bright spot here has been the dramatic turnaround in the first two weeks of February as oil prices have rebounded nicely from the mid-$40s to the low $50s (we don't think this is sustainable, see Surprise #8 below) has caused some meaningful short covering in the services sector and HCLP, SLCA and EMES rallied 23%, 26% and 32%, respectively. Another related energy idea we discussed was coal as we said that *"the Republican win in the Senate sets up the potential for legislation that will be more favorable to the coal companies, so if they can avoid bankruptcy in the near term, there could be some interesting opportunities in names like ACI, BTU, ANR, WLT, CNX and CLD."* This idea looked interesting for a couple weeks post-election as these stocks rallied hard, but then the euphoria faded and they collapsed to levels that caused severe losses over the period. The coal names were decimated, down (45%), (28%), (35%), (55%), (9%), and (33%), respectively, as discussion of bankruptcy reached a fevered pitch. Then just to confound all market participants, a massive short squeeze ensued on the first trading day of February and the coal cohort is up a robust 26%, 16%, 25%, 15%, 11% and 16% in the last ten trading sessions. We have commented that IF the coal companies can avoid bankruptcy, the equities will act like options and the returns can be huge, but the volatility makes these names nearly untouchable for most investors. Another industry given up from dead is the offshore drillers and we commented last quarter that *"the declines appear to be reaching extreme levels and there could be opportunity in names like RIG, DO, NE, EXV, ATW, RDC and SDRL, so we will be looking for signs of a momentum turn to wade into the space."* Like the coal names, the entire period was bloody with losses of (36%), (5%), (10%), (48%), (17%), (1%) and (46%), respectively, but again, like the coal names, a massive short squeeze began in February and these stocks have rallied 10%, 7%, 8%, 23%, 18%, 12% and 4% over the first two weeks of February. We expect energy to remain volatile for the balance of 2015 and we will be spending a lot of time looking at opportunities in both the debt and equity markets for all of our portfolios.

When we were doing our year-end ATWWY Webinar in December, someone asked the question if we saw anything surprising on the horizon for 2015. Rather than answer off the top of my head, I thought that sounded like a great topic for the January Around the World call and set off to come up with a list of 10 Surprises for the New Year. In thinking about the Market Outlook section for this quarter, these surprises seemed like a perfect baseline for our current view of the world. One caveat is needed, however, as Surprises are a little different than actual forecasts (although probably about just as accurate…) as they are intentionally created to be non-consensus and have some reasonable probability of not occurring.

The unlikely nature of a true Surprise is actually a really good thing, as they can be quite profitable as investments if you are positioned for them and they actually do occur. To frame the discussion of the 10 Surprises, I have included here a Definition, a Disclaimer and a Qualifier.

Definition: A Surprise is a variant perception (an idea that is materially different from consensus) that I believe has a better than 50% chance of occurring in the current year (the key is that it must be ***materially*** different).

Disclaimer: I have intentionally not read any of the other lists of 2015 Surprises (most importantly Byron's), so any similarity between the Surprises in this presentation and any of those predictions is coincidental or, perhaps, evidence (if they match the Blackstone list) that there was some channeling actually going on…

Qualifier: There is much wisdom about the folly of prediction (some of it listed below) and it would probably have been wise to decline the request to produce this list… That said, the process of thinking about Variant Perceptions and Scenarios is valuable to our investment process and it was actually kind of fun to spend some extra time thinking outside the box.

In the presentation, I listed three great quotes about the folly of making predictions that would be helpful to keep in mind:

"Making predictions is hard, especially about the future…" Yogi Berra

"The financial markets generally are unpredictable. So that one has to have different scenarios... The idea that you can actually predict what's going to happen contradicts my way of looking at the market." George Soros (interesting that one of the quotes was from George even before I knew the theme of the letter would be about him).

"Those who have knowledge don't predict. Those who predict don't have knowledge." Lao Tzu

So we offer these Surprises more as examples of Variant Perceptions, to prompt debate and discourse, realizing that should they actually play out (likely that half will -- the problem is determining which half…), they could lead to very profitable results since they are contrary to the current consensus and they are likely not priced into the markets. Another point to be mindful of is that a year is a long time, things can change, sometimes dramatically and we need to remember the wisdom of John Maynard Keynes who famously quipped, *"when the facts change, I change my mind, what do you do, sir?"* We will remain vigilant during the year to track the progress of each of these Surprises and look for opportunities to capitalize on them in the portfolios, but will also be ready to change our minds (and our positioning), should the facts change.

Surprise #1: The Lula Pivot. *In a déjà vu experience harkening back to the 2002 Brazil elections, the radical Syriza Party wins the Greek Election (was still a potential surprise since wrote before election), but Alexis Tsipras turns out to not be as extreme to the left as expected (just like Lula) and the Greek equity market surges (just like Brazil did for next five years), turning out to be one of the best performing markets for 2015.*

When Luiz Inácio Lula da Silva was campaigning to become the President of Brazil in the early 2000s, the world believed that he was a radical extremist who would do irreparable harm to the country if elected. In fact, during the six months leading up to the election in October of 2002, the Ibovespa Index fell (50%) as polls showed that Lula was to be the next President. Shortly after he was elected, it became apparent that Lula was not only a shrewd politician (he knew what the populace wanted to hear in order to get elected), but he was also a more centrist, business-oriented leader and the equity markets in Brazil began a multi-year rally that took stocks up more than 8X over the next five years. Some would argue that the equity rally was simply a function of the China led commodity boom (clearly that was a factor), but there is no question that Lula's strong leadership was a primary factor in the recovery. The story of Alexis Tsipras in Greece follows the same script, he was branded a radical extremist, the markets fell more than (50%) leading up to (and right after) his election and it appears that he is slowly leaning more toward the center already. Many will say that Greece has nothing to sell to the global market place the way Brazil did, but it is not necessarily the volume of trade, but rather how low are the valuations of companies (one of lowest CAPE ratios in the world), how far along in the recovery (one of only European countries with positive GDP growth and record setting tourism this year) and how much capital will flow into the market (so far this has been the missing ingredient). Over the first two weeks of February, there has been a lot of sparring with the global media and some not so favorable games of chicken with the Troika and Mr. Draghi (Super Mario didn't blink). We believe that the rhetoric will continue to soften, both sides will compromise (just like they did in 2011, but likely not quite as extremely in favor of the EU this time, no more Austerity) and the markets will continue to recover as the uncertainty of the election is replaced by the focus on the work that has to be done. We see opportunities in both Greek Government Bonds and Greek equities (particularly the banks, where, in full disclosure, we have been early/wrong so far…) and while the path will not be smooth, we expect that returns will be quite attractive over the course of the year.

Surprise #2: Turning Japanese, I Really Think So. *Despite the BOJ and the ECB picking up the QE baton from the Fed and committing to purchase $80B and $65B of government bonds each month respectively, Deflation reemerges as the primary economic challenge in the developed world, GDP growth stalls and global interest rates continue to fall.*

The Bank of England, the Swiss National Bank and the Fed have all taken a break from the QE relay and have stopped expanding their Balance Sheets. They have collectively passed the baton to the BOJ and the ECB (which finally convinced the Germans that they needed to do something) and the global liquidity pump will continue to be primed in 2015 (at least that is what Mr. Draghi said would happen in March, but they have never actually bought any bond they said they were going to in any other program...). Hope continues to spring eternal in the GDP forecasting game as the pundits all over the world still have robust growth expectations for global economies (despite actual evidence that the developed markets have not even come close to those estimates for years). The expectations for the U.S. to grow in excess of 3% seem quite heady (given the sixth consecutive year of sub 3% growth in 2014) and the forecast for Europe to return to expansion seems a bit optimistic given that France just slipped back in to Recession and the Leading Economic Indicators are turning down. Indicating even more slowing growth ahead, PMIs have turned down in most of the developed world and the Financial Conditions Index in both the EU and U.S. have rolled over hard, pointing to slower, not faster growth ahead. In addition, deflation is back in the EU (CPI just turned negative) and with the collapse in the price of oil, forward inflation expectations have crashed toward 1%, indicating risk of deflation in the U.S. as well. European bond yields are already at multi-century lows, with German Bunds now trading below JGBs, and a shocking 20% of European debt has negative yields today (that is $1.4 trillion worth). U.S. yields fell in 2014 contrary to all 67 economists polled to start the year, and yields have plunged again to start 2015. Almost no one believes that rates will keep falling, which can be seen in the massive short interest in Government Bonds, but the handful of people who have remained long (like our two favorite fighter pilots Hoisington and Horseman) continue to generate strong returns.

Surprise #3: Let's Do Limbo Now. *Contrary to the Fed Dots (new, new thing), the preponderance of Economists' predictions (just like in 2014) and the* *continually upward sloping Fed Funds futures curves (since 2009), the Fed does not raise rates in 2015 and long bond rates take out the 2012 lows in yield.*

One of my favorite charts of the past few years has been a cumulative chart of the Fed Funds Futures curves each quarter since 2009. The graph shows a colorful collection of upward sloping lines that essentially have predicted (incorrectly, obviously) that the Fed would raise rates between 0.5% and 2.5% over the 12 to 24 months. The current curve shows that short-term interest rates will be 1% by the end of this year (for perspective the 2010 curve said rates would be 2.5% by 2012 and the 2012 curve said rates would be 1% today, instead of the actual zero). The Fed Dots chart (each governor gets a dot to predict their estimate for rates each of the next three years) is even more aggressive, showing that the bulk of the Fed Board think rates will be 1.5% to 2% by the end of 2015. There is a near consensus that the Fed will begin to raise short-term rates in the summer (and that consensus grew louder with the strong January jobs data), yet both ten-year and thirty-year treasuries had rallied very strongly (yields fell hard) this year up until last week. We have seen this pattern many times in the past year, the bond bears growl loudly any time some U.S. economic number is relatively strong and rates rally a few basis points, before heading back down. The myopic focus on the U.S. economic data ignores the larger global deflationary trends that are pulling down rates all around the world and one thing we have observed over and over is that the 10-year Treasury follows the 10-year Bund, which is significantly lower. Finally, there is no mistaking the long-term trend channels on the 10-year and 30-year Treasuries, so until such time as yields break out of those channels, it is tough not to see lower for longer as the mantra in the bond market. One real beneficiary of the lower rates has been the housing industry and the housing stocks have been looking good lately, so they could continue to shine in a lower for longer environment and the Index XHB will do well, but some of the components like LEN, PHM, KBH, DHI, TOL and RYL could do even better. Another beneficiary of this trend will be the asset managers who specialize in fixed income and names like BLK, BK, LM, FII, WDR and STT could continue to have tailwinds.

Surprise #4: Here's to You, Mr. Kindleberger. *Confounding the conventional wisdom that the convergence of the 3rd year of a Presidential Cycle (average 21% return since WWII) and the 5th year of a decade (no down years since 1905) virtually guarantees a positive return for U.S. equities, the S&P 500 breaks the string of 6 consecutive up years and suffers its first losing year since 2008.*

We discussed Charles Kindleberger's Cycle Theory earlier in this letter but again, quickly, he posits that the economy and markets follow a seven-year boom/bust cycle driven by repeatable investor behaviors. Given the last two cyclical peaks were in 2001 and 2008, we would be due for another peak in 2015 that would result in disappointing returns for U.S. equities. That said, the trend data is extremely positive for the S&P 500 in 2015 with four indicators predicting very strong returns. First, the twelve months following a mid-term election have never been negative (since WWII) and have averaged 16%. Second, the third year of the Presidential Cycle averages 21% (with only two flat years since WWII). Third, when the Strategas Trend Model is positive in December, the market is up the following year a stunning 94% of the time. Fourth, there has not been a mid-decade year (end in 5) in this century with a negative return, in fact the bulk of years have been above 25%. Yet, there is a countervailing trend that is interesting, insofar as it aligns with Mr. Kindleberger's periodicity. The S&P 500 has never been up seven years in a row. So, as 2015 progresses, we will see if the S&P 500 will be the anti-Craps game this year and roll a lucky seven. The one wildcard related to this Surprise is that the math is predicated on no more QE, as we still believe that for every $100 billion of Fed Balance Sheet expansion, the S&P 500 will rise 40 points (about 2%). If the Fed changes course (or does some stealth purchases, which have recently been reported) then there could be some additional ammunition pushing for the lucky seventh.

Surprise #5: TMI Writ Large. *Despite an ongoing military conflict in Ukraine, the impact of coordinated global economic sanctions, rapidly falling oil prices, reduced government tax revenues, a collapsing currency and a looming economic downturn and downgrades of their government debt and consensus that Russia is simply "un-investable", Sir John Templeton turns out to be right that Bull Markets are born on Pessimism and Russian equities turn out to be one of the best global markets in 2015.*

The Russian equity market was a disaster for international investors as the collapse in oil prices in the second half of the year triggered a plunge in the Ruble that caused any investor who was not hedged back to local currency to lose upwards of (45%), (depending on the currency). Actually, the Russian equity market itself was surprisingly stable given all the macroeconomic and geopolitical challenges in the region, but prices are so incredibly low (total market P/E is below 5) that investors who have stayed the course are long-term focused strong hands. Looking ahead into 2015, the Russian economy is poised to return to Recession (thanks to the oil price decline) as current oil prices are predicting a 5% contraction in the economy (although Russian forecasters say only 1%) and one could conclude that the equity market will follow the economy down. An alternative view is that the market has been a leading, not lagging, indicator and with the RTS Index already down (55%) cumulatively over the past four years, perhaps the economic performance is irrelevant to stock prices at this point. In looking back at the last big drop in oil in 2008, Oil collapsed (70%) and Russian stocks were down (75%) to (85%), (depending on the index), but then were up a staggering 140% in 2009, handily outpacing the global equity markets and the oil rebound of 20%. While not forecasting precisely the same kind of rebound given that there is not the same level of global stimulus from China and the U.S. this time around, but given the extremely cheap valuations, the potential for a meaningful positive surprise exists. So far in 2015 Russia has appeared to decouple slightly from oil prices and the prospect for a true cease fire in Ukraine would be an additional tailwind to move from Pessimism to Skepticism, the state where Bull Markets really grow.

Surprise #6: All That Glitters. *The acceleration of the Global Currency War reignites the demand for the ultimate currency, Gold, and the Barbarous Relic surges to new highs in 2015, carrying the miners along for the ride.*

As the global currency wars rage and the QE baton is passed from the U.S., U.K. and Swiss Central Banks to the BOJ and ECB, it has been interesting this year to watch precious metals suddenly begin to trade like currencies again. CYTD, Silver is up 10%, Gold is up 4%, the Dollar is up 3.5%, the Yen is up 1%, the AUD is down (4%) and the Euro trails the pack, down (6%). It has been amazing to watch how quickly all investors jumped on the long side of the S.S. King Dollar and the trade was feeling extremely crowded right into the ECB announcement of their form of QE (not real QE, but a way for the individual country Central Banks to buy government bonds) and everyone expected the Euro to get hammered and the Dollar continue rising, but, of course, the opposite happened and the Euro has been strengthening slightly since the 22nd and the Dollar peaked on the same day. Interestingly, gold came into the year with some modest momentum, having jumped 12% from election day last year to the ECB announcement day (while the S&P 500 was up only 2% over same period) and had made an important break out above the 200dma in mid-January. Gold has rallied hard from $1,150 back to $1,300 in just over a month and we were showed a graph that highlighted resistance overhead at $1,350 and there was also data that showed how gold had become overbought and might be due for a pullback. As if on cue, gold rolled over on the ECB announcement day (and was hit hard again with the strong jobs number) and has now retraced about a quarter of the gain (that said, gold is still up 4% YTD 2015 vs. flat for the S&P 500). One other interesting point is that the ratio of XAU (NYSE Arca Gold BUGS Index) to Gold Bullion reached the lowest level in history at the end of 2014 and given that gold had seemingly turned more positive, it appeared that gold miners were due for a rally. Rally they did, for the first few weeks of 2015, XAU surged close to 20% before rolling over on the ECB QE announcement and have given back about 40% of the gains, but the miners are still up 12% CYTD.

Surprise #7: Water Finds Its Level. *Central Banks in the Emerging Markets are forced to stimulate their economies in response to the massive BOJ and ECB bond purchase programs and the resulting expansion of liquidity unlocks the extreme value in Emerging Market equities leading them to outperform the developed markets for the first time since 2012.*

One of the challenges facing Central Bankers in the Emerging Markets over the past few years has been the surprising rise of inflation in many EM countries, surprising because the problem for the Developed Markets has been fighting deflation, which allowed them to stimulate and boost asset prices. The higher levels of inflation made sense given the better demographic profile (more young people leads to higher inflation, more old people leads to more deflation) and higher growth in the EM, but were creating challenges for EM Central Bankers to keep pace with the liquidity explosion in the DM. However, the rapid fall in commodity prices, particularly oil and food, was creating a window of opportunity for the EM CBs to join in the rate cutting and bind buying party. We have seen a number of surprise rate cuts recently in places like India and China, where the majority of the CPI is food and energy as inflationary pressures have waned. Many things have changed in EM in recent years, but one thing that remained constant is the relative level of growth vs. the DM and while that growth has continued to be quite robust, investors' fears about Fed Tapering and slowing rates of growth (rather than focusing on rising quality of growth) has pushed prices down to levels where the valuations are extremely compelling.

When looking at two measures of relative attractiveness, market cap/GDP and P/E to Growth ratios, we see some very compelling values. Market cap/GDP (the Buffet Indicator, as it is called, since Warren prefers this method of looking at overall valuation) should range from 70% to 120% to be average, higher is expensive and lower is cheap. Many countries fall right in the normal range, but there are some outliers on both sides. On the expensive side, Switzerland and Singapore stand out at 230% and 180%, but they are unique given their very small GDP and their holding company friendly jurisdictions that have attracted many foreign companies to list there. The U.S. is definitely in the expensive camp (although not as extreme as in 2000) at 139% and the U.K., Malaysia and South Africa are pretty expensive as well. On the cheap side there are some crazy low numbers (some very compelling opportunities) with Argentina at an incomprehensible 10%, half again as low as Russia at 19% and two-thirds lower than Brazil at 35%. Interesting on the cheap side is Germany at 47% (which is up nearly 10% CYTD, perhaps driven by value buyers in addition to Euro skeptics) and China, despite the big rally in Q4, is still quite cheap at 49%. Another measure of cheapness, P/E to Growth (PEG Ratio) shows that DMs are quite pricey relative to their reduced growth profile. The PEG ratio for Global Equities as a whole is 4.6, but looking at DM, the PEG ratios are much higher with the U.S. at 7.7, Germany at 9.0 and Japan at 16.9, while EM are much lower with overall EM at 2.6 and some notable markets like India and China at 3.1 and 1.7. Looking more closely at India, the P/E appears higher than other EM, but that is because the Index has more technology companies (higher P/Es) and less commodity companies (lower P/Es) than the other EM countries. We think India looks very attractive, particularly given the momentum created by Modinomics and the surprise easing of interest rates by Central Bank Governor Rajan. In a very bullish sign for Indian equities, local investors are buying stocks, in size, for the first time since 2008.

Surprise #8: No Fracking Around. *Contrary to the current consensus that Oil prices have bottomed and will rebound back to $70-$80 by year end, continuing liquidation of speculative long futures positions drives Oil down close to the 2008 lows ($30) and prices stay in the $40-$50 range much longer than expected as structural challenges in the U.S. and OPEC make it difficult for market participants to move supply/demand back into balance.*

The oil market has been one of the best examples of Reflexivity in action in the past few years as a combination of a massive increase in non-commercial investors, an explosion of energy debt issuance and the resulting boom in U.S. production created a virtuous cycle that crested in June of last year and transitioned to a particularly nasty vicious cycle with frightening speed. Looking back a little bit, in the wake of the Global Financial Crisis, oil prices had stabilized around $40 and there was a common belief (misconception) that oil prices wouldn't recover any time soon (they had peaked at $147 right before the Crisis) as demand was expected to remain moribund and supply looked very healthy. There was consensus (a misconception) that prices couldn't recover in the wake of the global economic slowdown and there were literally no commercial long positions in the futures markets. As usually happens when sentiment reaches these extremes (and Central Banks throw trillions of dollars of stimulus at the global economy), demand rebounded sharply and demand exceeded supply for nine of the next twelve quarters as prices began to rise quickly. As prices rose from $40 to $80 over the next year, market participants reacted in the expected reflexive manner and began to build speculative net long positions again, which pushed prices higher. The reflexivity between the supply/demand imbalances and the rising volume of investors playing catch-up pushed prices above $100 in 2011. A brief period of volatility occurred around the U.S. debt downgrade and the threat of a Euro-Crisis triggered by a "Grexit" (Greece exiting the Eurozone, sounds familiar…) pushed prices back down toward $80, but the quick resolution of the problem when Draghi said he would do "whatever it takes" to save Europe was all the oil market needed to push into a speculative long buying frenzy over the next couple of years culminating in the massive 460,000 net long contracts position in June of last year (essentially four paper barrels of oil for every real barrel of oil).

As Soros says, every bubble has, at its root, a basis in reality distorted by a misperception. Investors did not understand how the reflexive response of lenders into the shale oil business was actually changing the fundamentals of the oil market by fueling a huge drilling boom that resulted in U.S. oil production growing from 5.5 million barrels a day in 2012 to nearly 9.5 million barrels a day in 2014. So long as oil was above the perceived marginal cost of $80, banks would lend with reckless abandon and they pumped $550 billion into E&P companies all over the oil patch. The American Energy Renaissance was upon us and the speculative fever to capitalize on what would be a one-way ticket to riches reached a fevered pitch, reaching an apex at the virtuous cycle peak in June. Unfortunately, investors missed a couple of developments that would, once again reflexively, turn the cycle from virtuous to vicious very rapidly. When the U.S. production levels grew by 1.3 million barrels in a single year, suddenly the market moved from balanced to oversupplied and some of the longs began to take profits, causing prices to begin to slip. Market participants embraced another misperception that oil couldn't possibly go much below the marginal cost of production and everyone was sure that there was a floor in the market around $75. Perhaps the most comical (with the benefit of hindsight) was that the EIA (the world's largest energy information entity) predicted that there was 95% certainty that oil prices could not go below $80 in 2014. However, prices kept falling, pausing only briefly at $75 right before the big OPEC meeting on Thanksgiving Day, where everyone was once again sure that Saudi would cut production and bring the market back into balance (because all the OPEC countries needed $100+ oil to balance their budgets). The resulting shock to the system when Saudi decided not to cut was swift and reflexive, prices fell dramatically, more sellers tried to liquidate and prices collapsed down into the mid-$40s.

So the bottom callers have come out once again saying that oil prices have seen their lows and that prices will rapidly recover to their 2014 levels. Why is everyone so sure this will happen? Why is there not one (not one…) Wall St. analyst with a year-end price target for oil below $60? Primarily because everyone is looking at the data from 1995 on that shows that each time oil prices have dropped precipitously, they have rebounded sharply (just like stocks in the QE Era, it has paid to buy the dips), but the problem is that each drop since 1995 was a demand shock, not a supply shock, and demand shocks have been cured by the massive stimulus propping up consumption and encouraging speculation (the spec longs have actually increased again), while supply shock recoveries are measured in years, not months. We haven't seen a big supply shock since 1985, but that one kept oil prices down for nearly three years as Saudi reasserted control of the markets, which appears to be precisely what they are doing this time. Two other factors that are being overlooked (market participant misperceptions) are: 1) the steep Contango (upward sloping futures curve) in the oil market is encouraging a massive build in storage (tanks, Very Large Crude Carriers, tankers, etc. are being loaded with oil to sell later at higher prices) which will eventually come to market and depress prices and 2) much of 2015 U.S. production is hedged at higher prices and many leases have clauses that require the properties to be drilled in order to maintain control, so 2015 production is likely to rise, not fall, which will further pressure the supply/demand problem. Add the fact that Iraq just announced new highs in production and Libyan production has come back faster than anticipated and it appears unlikely that the markets will be back in balance any time soon.

So why are prices rallying in the past couple of weeks from the mid-$40s to the mid-$50s and why is the media trumpeting a new bull market in oil? There was a surprise in the markets on the last day on January when the GSCI Index rebalancing (oil had fallen so much that the Index had to buy a lot more futures) caught some investors off guard and triggered a sharp short covering rally (while there are still net speculative longs, there are a lot of shorts too) of 7% that Friday. Over the past couple of weeks, the oil markets have been very volatile, rising and falling more than 3% on most days, with more up days than down recently, resulting in the move upwards. Soros says that volatility always increases at turning points, so there is an increasing number of pundits claiming that the trend is about to change back to positive and oil will surge for the balance of the year. We remain skeptical, and while we are not as bearish as Citi, which recently published a report on why oil could easily fall to $20 this year before recovering, we continue to believe that the consensus for a steep rebound will be proven wrong as the fundamentals trump the recent speculative activity. Two other considerations are: 1) there is a seasonal pattern in oil that makes lows around the spring shoulder (transition from heating to driving season) in April and heads higher during the summer months and 2) there could be a demand response to the lower prices that increases consumption and brings the market closer to balance. We will monitor these developments, but so far, the fundamentals point to continued weakness with significant volatility (an amazing stat here is that there have been more days in 2015 where oil has moved >5% intraday than in 2012, 2013 & 2014 combined) as market participants determine whether we will see more "vicious", or a switch back toward "virtuous". One last related point to keep an eye on is that the banks have huge derivative exposure and loan exposure to the energy industry that could cause some pain as the market begins to adjust around mid-year, so the swoon in bank stocks in January could be foreshadowing some interesting times ahead.

Surprise #9: Only Way Out. *Kuroda-san and the BOJ pull out the bazooka again in 2015 taking aim at a*

USDJPY level of 140 in an attempt to stimulate profits of Japan Inc. so they will raise wages, triggering a virtuous circle to break deflation and achieve the 2% target inflation rate. Japanese equities tag along for the ride and the Nikkei reaches 22,000 by year-end.

Since the announcement of the Abenomics three-arrow attack in November of 2012, the program has produced some spectacular results, as the Yen declined from 78 to 120, the Nikkei more than doubled from 8,500 to 17,900 and the deflation genie has seemingly been put back in the bottle as the CPI is solidly positive (with Core CPI actually right around the BOJ target of 2%). Perhaps even more importantly, thanks to the continued commitment by the Kuroda-san to expand the QQE program, the forward expectations of inflation are rising for the first time in decades. While there has been a growing chorus of skeptics on Japan (and Abenomics in particular) we are emboldened in our positive view of the Japan market by Sir John Templeton's reminder that bull markets grow on skepticism. We are also mindful that amidst the assertions that Japanese equities have gone too far, too fast, and that the weak Yen is actually hurting the domestic economy, we simply remain focused on the data which shows a gradual recovery of growth following the setback after the Consumption Tax increase (like the huge rebound in machine tool orders this month) and point to the long-term chart of the Nikkei which shows that there is still tremendous head room to recover the previous highs from two decades past.

Corporate profits at Japan Inc. continue to set new records and the shares of export-oriented companies (like the car companies Toyota and Fuji Heavy (Subaru) and electronics companies like Sony and Panasonic) continue to make new highs, on top of very robust advances in the past two years. A bonus here is that, surprisingly, Japanese equities are actually cheaper today than before the rally started because the earnings growth has been so robust. Our expectations are that the BOJ will continue to remain accommodative and provide liquidity to fuel continued margin expansion, further increases in ROE and higher stock prices. At the core of Abenomics is a commitment to continued weakening of the Yen (some might say they have no alternative…) and we would expect to see 140 on the USDJPY by the end of 2015. My good friend, John Mauldin, said at a conference in Cayman in early February, where we both were speaking, that the Yen will see 200 and then 250 in the years to come. This move will not be linear and we do see some resistance at 123 (and correlated resistance for the Nikkei at 18,400), but once those levels are cleared, we expect to see the 140 and 22,000 levels of surprise #9 achieved later this year. A couple of risks to this outlook are that 1) there is some sort of global equity disruption that results in a flight to safety that would include the Yen and the Yen actually strengthens versus the dollar, or 2) the Chinese suddenly decide to engage in the global currency wars and devalue the RMB which would lead to a temporary strengthening of the Yen as JPYRMB carry trades are forced to be unwound.

Surprise #10: Goats Climb Mountains. *In spite of the cacophony of bad news about slowing GDP growth, an impending economic hard landing, a potential currency collapse, a looming banking crisis and a pervasive real estate bubble, coupled with fears that huge returns in the Shanghai market in 2014 have pushed equity markets too far, too fast, China officially enters a new Bull Market and equities (both Hong Kong and Shanghai) rally strongly again in 2015.*

Hardly a day goes by that you don't read a headline about another headwind for the Chinese economy, a dire prediction of a hard landing or an assertion that the "books are cooked" or that "the numbers don't add up." What always seems to be missing from these hyperbolic proclamations is some analysis, on linkage, back to the Third Plenum Reform Agenda that the New Leadership in China laid out before coming to power that they were intent on cracking down on corruption, shifting growth from fixed asset investment toward consumption and providing a more streamlined regulatory environment that would encourage innovation and growth. Powerful Reformers over the course of history have been very Bullish for equity markets and we can harken back to the Reagan/Thatcher era to see similarities to what Premier Xi is attempting to achieve in China over the coming decade. We believe that this Reform Agenda has set the stage for a powerful and long-lasting bull market as the reflexive synergies between global market participants and the Chinese economy fuel a virtuous cycle of development in the years ahead. The tremendous success of the Through Train Program that has increased equity activity is just one example of how the New Leadership is pushing the economic model beyond the property markets into other asset markets. China is also huge beneficiary of the drop in oil prices and as inflation has moderated, the PBoC has been able to increase money supply growth again, which has established a tailwind for financial assets. They have been able to cut interest rates and lower the Reserve Requirements for the banks which has spurred new loan growth, which, in a reflexive manner, enables investors and companies to expand, thereby improving the fundamentals of the overall system, resulting in increasing prices.

One surprise within the surprise has been the willingness of the PBoC to allow the RMB to weaken (essentially engaging in the global currency wars) to spur higher exports, leading to higher profits from a number of sectors and industries. In 2014, it was the A-Shares market that led with spectacular gains of 53%, but so far in 2015, it has been time for the H-Shares and SOEs to play catch-up. We would expect to see strength across all Chinese equity markets in 2015 and there is some possibility that the virtuous cycle could produce the type of robust bull market that we saw in the U.S. in the mid-90s. To that point, we continue to see the best opportunities in five sectors, Internet, e-Commerce, Consumer Staples, Healthcare and Alternative Energy and are particularly excited about the growth potential in e-Commerce which (according to a CLSA report) could compound at 26% a year for the next decade. Even more astonishing is that the Mobile segment of e-Commerce is expected to grow at 52% per year for the next decade, which when you do the math of 1.52^10th power, you get a market that would expand by 66X, a target rich environment indeed. Another point worth thinking about was made during a great discussion during our OCIO Roundtable during the KPMG Cayman Alternative Investment Summit, that the Chinese market appears to be in a period very similar to the U.S. when long/short strategies produced particularly strong returns due to the creative destruction that leads to big winners, and big losers, as an economy transitions toward consumption.

Bonus: Surprise #11: Little Luxuries Not Enough. *In contrast to the powerful narrative, the huge windfall for U.S. consumers from lower gasoline prices fails to materialize as some of the savings are applied to reduce debt and increase savings and the loss of jobs from the economic downturn in the Oil States counteracts the positive impact of the balance. U.S. Real GDP growth hovers around 2% (for the 6th consecutive year) and talk of QE4 begins in the fall.*

When I was creating the 10 Surprises, I got on a roll and actually came up with an extra one that originated from all the hoopla around the consumer windfall that was coming from lower gas prices. Numbers were being thrown around in the media of $200 billion to $300 billion and expectations were very high that all this money would immediately flow into consumption and boost GDP. But a funny thing happened between the gas pump and the mini mart. Consumers did buy a few extra packages of cigarettes (MO, RAI, LO surged) and a few more bottles of beer (ABI:BB, HEIA:NA, SAB:LN surged) and did actually buy a little more from Wal-Mart (WMT), but the overall retail sales figures (just released) actually fell, showing that consumers held on to some of those savings, perhaps to pay down some debt or maybe sock away some savings in the event that the low gas prices were fleeting (gas prices actually have risen slightly during February). As the "Surprise" title implies, an extra lottery ticket or a cup of coffee at Starbucks (SBUX) won't juice GDP enough to make up for the lost purchasing power of the 100,000 people whom are expected to lose jobs (high paying jobs) in the oil patch and we don't expect to see U.S. GDP hit the 3% level in 2015, for the seventh year in a row. One interesting area that has seen strong rising demand is movie theaters and AMC, RGC, CNK, CKEC, NCMI and MCS have all been very strong lately as it appears date night at the movies still is a little luxury (and we won't all sit at home alone watching NFLX). Another beneficiary of lower oil prices will be the car companies and global auto manufacturers who are suddenly selling more SUVs and Trucks (higher margins), stocks like DAI:GR, PAH3:GR, BMW:GR, TTM racing, and even the U.S. companies F and GM have been picking up of late. Another interesting development related to this Surprise is that despite a lower than anticipated Q4 GDP print, the cyclical stocks have been behaving as if growth were going to accelerate (hope springs eternal), so we will keep our eye on the semiconductors as they are a group that usually signals stronger growth ahead, so names like BRCM, KLIC, MRVL, LLTC, MSCC, NVDA and TXN have been solid and even two big names that had struggled early in the New Year, MU and QCOM, have turned sharply along with the oil rally in February.

Surprises. We think 2015 is likely to be a year full of surprises as it continues to feel a lot like the last time there was so much "certainty" in the markets about New Paradigms and New World Orders, back in 2000. When investors have reached that reflexive maximum and are all leaning one way in certain markets, the impact of surprises is much greater. In 2000, everyone was certain that Internet valuations were reasonable, that Indexing was the only way to invest and that there would never be another Recession because the Fed had abolished the business cycle. Sounds familiar. Given this consensus, we will maintain our baseline for the big positions, leaning toward Active Management, away from Passive and Indexes, toward Hedged Strategies and away from Long Only in the U.S., toward Private Investments over public investments whenever possible (emphasis on Small Buyouts, Growth Capital (with extra emphasis in EM), Energy and Lending), toward Emerging Markets over Developed Markets and toward Real Assets relative to Financial Assets. Importantly, if the 2015-2017 period does indeed follow the analog of the 2000-2002 period, there will be ample opportunities on the long side, on the short side and in the private markets, even if the overall environment turns out to be challenging for traditional assets. We continue to see the risks of deflation outweighing the risks of inflation, yet there still seem to be some attractive opportunities in real assets as we look forward. Perhaps, the biggest Surprise of all would be something we stated last quarter *"that if real assets were to somehow outperform financial assets in the face of the huge consensus opinion that commodities will crash and burn, shot down by King Dollar."* A few examples of companies that could be big winners if the commodity super cycle resumes are VALE, BHP and FCX and the steel companies like X and AKS (or if we want to get really fancy we can combine Surprises and go for a Russian steel company MTL). Another area to think about is the public management companies of the private equity firms which will take advantage of the opportunities in distressed debt, energy and M&A and names like BX, OAK, KKR and CG could provide solid returns in an environment where the illiquidity premium continues to be rewarded.

In closing the Market Outlook section last quarter, we wrote, *"as we head down the Highway to the Danger Zone and anticipate an interesting (read challenging) year for investors in 2015, we are reminded of a couple of truisms in generating strong long-term investment returns: 1) Follow Roy Neuberger's three rules, i) don't lose money, ii) don't lose money and iii) don't forget the first two rules, 2) Invest without emotion and focus on eliminating unforced errors, and 3) You can't predict, you can prepare."* The last point could have easily been said by George (rather than Howard Marks), as the notion that you can't predict fit well with Soros' way of looking at markets and he was laser focused on always being well prepared. Interestingly, his method of preparation was quite different than most, which we will discuss below. Reflexivity says that prices in the market do not reflect true value because of the misperceptions and biases of the participants. Similarly, Soros asked rhetorically ***"how good are markets in predicting real-world developments? Reading the record, it is striking how many calamities that were anticipated did not in fact materialize. Financial markets constantly anticipate events, both on the positive and on the negative side, which fail to materialize exactly because they have been anticipated*** **(reflexivity in action again)*****. It is an old joke that the stock market has predicted seven of the last two recessions. Markets are often wrong."*** So the idea of an overall Market Outlook would be anathema to Soros as he was more prone to using the reflexive nature of the markets to help him create his views. Invest first and then investigate. Basically, Soros would create a hypothesis (back to his Philosophy training under Popper), take a toehold position to test the hypothesis, and wait for the market to prove whether he was right or wrong. If the market went against his position and he felt uneasy (e.g., gets a backache), he would admit his mistake and cut his losses. Another critical component in forming an investment idea was to use "Devil's Advocates," Soros said ***"if you have an investment thesis you like, run it by people who support the other side of the argument. See if you still like the thesis afterward."*** Another unique aspect to the way Soros would think about ideas was that he preferred to talk to only ***"a select few people who can be really helpful"*** rather than pay attention to the plethora of constant information from sources that he did not deem critical. Soros was very big on disengagement. He believed it was critical to take time to really think, he said ***"to be successful, you need leisure. You need time hanging heavily on your hands, to talk to people, read, and reflect."*** Finally, Soros (like many other great investors) believed it was important to be selective, to really pick your spots. Buffett would say that you don't have to swing until you get the *"fat pitch"* because there are *"no called third strikes in investing"* and Jeremy Grantham would say that *"you only need one or two really good ideas a year."* Soros summed up his version of this idea in a conversation with his friend Byron Wein (formerly of Morgan Stanley, now Vice Chairman of Blackstone), when he said ***"the trouble with you Byron is that you go to work every day and think you should do something. I don't, I only go to work on the days that make sense to go to work and I really do something on that day. But you go to work and you do something every day and don't realize when it's a special day."*** Listen, read, reflect, form a hypothesis and let the reflexive nature of the markets tell you when you are right, then really do something special, be a pig. The wisdom of George Soros summed up in a few clauses. We have been listening to the markets, reflecting and can see a handful of ideas developing where we can build meaningful positions to take advantage of the virtuous cycles that are developing and protect us from the vicious cycles that are approaching on the horizon.

Update on Morgan Creek

Andrea Szigethy continues to take investor education efforts to the next level with the rebranding of the North Carolina Investment Institute ("NCII"). While the content and logistics of the event will be the same, NCII will now be a membership organization open to investors and managers in the Southeast. Membership grants access to all NCII events held throughout the year. We believe the rebranding of NCII will allow us to give our investors and other members of the investment community access to some of the Industry's most sought after speakers and investment professionals. As always, there is no fee for Morgan Creek advisory clients to join the organization and they are automatically considered honorary members with free access to all events. Please mark your calendars for this year's Spring Forum which will be held on May 18-19 at the Umstead Hotel in Cary, North Carolina. While the event is still a few months away, we are already extremely excited about our speaker list which already includes some of the best in the business: Kyle Bass, Dennis Gartman and Daniel Clifton. For more information about the Institute or the 2015 Spring Forum, please visit www.ncinvestmentinstitute.org or contact Andrea or Donna Holly directly at andrea@annualconnect.com and donna@annualconnect.com.

You should continue to receive monthly invitations to our Around the World with Yusko webinar series. We hope these webinars are educational and interesting for those of you who log-on. As always, we are happy to provide replays and presentations to any call you may have missed. Please save the date for the February 24th "Itinerary for 2015" webinar at 1:00pm EST where I will present Morgan Creek's best ideas for the year. The March 26th webinar at 1:00pm EDT will focus on the Private Equity Illiquidity Premium which is fitting given the recent launch of our private equity funds. For more information about Around the World with Yusko or to be added to our mailing list, please email us at IR@morgancreekcap.com.

We believe 2015 will present great opportunities for the Firm and we are excited to grow and continue to expand on the solutions we provide our investors. We hope you will be able to join us in May for the North Carolina Investment Institute and look forward to seeing you then.

With warmest regards,

Mark W. Yusko
Chief Executive Officer & Chief Investment Officer

General

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Russell 3000 Index (DRI) — this index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. Definition is from the Russell Investment Group.

MSCI EAFE Index — this is a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the US & Canada. Morgan Stanley Capital International definition is from Morgan Stanley.

MSCI World Index — this is a free float-adjusted market capitalization index that is designed to measure global developed market equity performance. Morgan Stanley Capital International definition is from Morgan Stanley.

91-Day US T-Bill — short-term U.S. Treasury securities with minimum denominations of $10,000 and a maturity of three months. They are issued at a discount to face value. Definition is from the Department of Treasury.

HFRX Absolute Return Index — provides investors with exposure to hedge funds that seek stable performance regardless of market conditions. Absolute return funds tend to be considerably less volatile and correlate less to major market benchmarks than directional funds. Definition is from Hedge Fund Research, Inc.

JP Morgan Global Bond Index — this is a capitalization-weighted index of the total return of the global government bond markets (including the U.S.) including the effect of currency. Countries and issues are included in the index based on size and liquidity. Definition is from JP Morgan.

Barclays High Yield Bond Index — this index consists of all non-investment grade U.S. and Yankee bonds with a minimum outstanding amount of $100 million and maturing over one year. Definition is from Barclays.

Barclays Aggregate Bond Index — this is a composite index made up of the Barclays Government/Corporate Bond Index, Mortgage-Backed Securities Index and Asset-Backed Securities Index, which includes securities that are of investment-grade quality or better, have at least one year to maturity and have an outstanding par value of at least $100 million. Definition is from Barclays.

S&P 500 Index — this is an index consisting of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The index is a market-value weighted index – each stock's weight in the index is proportionate to its market value. Definition is from Standard and Poor's.

Barclays Government Credit Bond Index — includes securities in the Government and Corporate Indices. Specifically, the Government Index includes treasuries and agencies. The Corporate Index includes publicly issued U.S. corporate and Yankee debentures and secured notes that meet specific maturity, liquidity and quality requirements.

HFRI Emerging Markets Index — this is an Emerging Markets index with a regional investment focus in the following geographic areas: Asia ex-Japan, Russia/Eastern Europe, Latin America, Africa or the Middle East.

HFRI FOF: Diversified Index — invests in a variety of strategies among multiple managers; historical annual return and/or a standard deviation generally similar to the HFRI Fund of Fund Composite index; demonstrates generally close performance and returns distribution correlation to the HFRI Fund of Fund Composite Index. A fund in the HFRI FOF Diversified Index tends to show minimal loss in down markets while achieving superior returns in up markets. Definition is from Hedge Fund Research, Inc.

MSCI Emerging Markets Index — this is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of November 2012 the MSCI Emerging Markets Index consisted of the following 23 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates.