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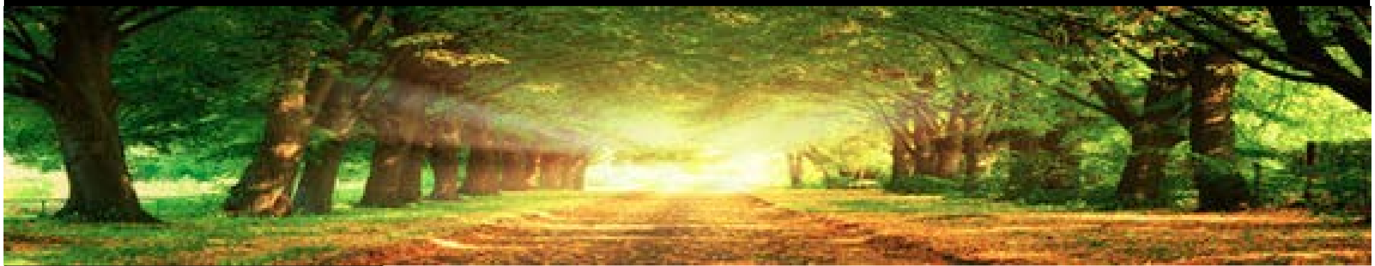

Celestial Wealth Management

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Challenge Your Mind

Next month, my newsletter will be focused on the current markets and a mid-year update on where things stand. For this letter I thought a good topic would be to challenge your mind. When talking about the United States stock market, recently I have heard statements in the financial media such as:

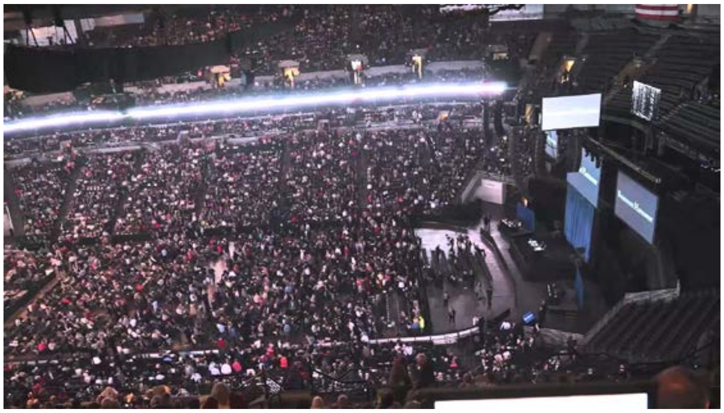
- "It's not as overvalued as 1999
- We lack the Euphoria we saw in 2000
- Interest rates are low so current stock values make sense
- There is no other alternative to the stock market (TINA)

These are statements that should make the hair on your neck stand up. The first two statements, may in fact be true, however 1999-2000 was the highest market valuation in history. **Comparing today versus the one time in history** where things were more overvalued seems silly to me. The third statement makes sense to me with a caveat; Interest rates must stay down at these levels for a long….time. The last one is just false. There are other options, such as cash, foreign bonds, domestic bonds, etc. However, the trade-off is often a substandard…yet positive yield if held to maturity.

Investing is a constant learning process. Every year I learn more and more and pass that information on to my clients. He who ceases to learn ceases to grow. In my sixteen years in the business, I have found that reading about the world's great investors, speculators and businesses can help immensely. Rather than listening to those whose number one priority is to get eyeballs, sell advertisements or entertain, I prefer to listen and read those with skin in the game. It's crazy, I know, but those who have been successful in the past, are often times successful in the future.

As we continue through this newsletter I challenge you to open your mind to non-conventional thinking. What is interesting to me is that while many successful investors have different ways of compounding wealth, there are often similar traits that flow through their processes.

Thoughts from Charlie Munger and Warren Buffett



One of the most highly anticipated investment events of the year is the Berkshire Hathaway Annual Investors' meeting in Omaha, NE. More than 30,000 people from around the world travel to Nebraska and wait to get in Chesapeake Arena as if they were about to see The Rolling Stones. Nope, its just Warren Buffett and Charlie Munger. Two of the most unabashed United States bulls. For all the doomsayers out there, **Charlie and Warren first and foremost believe that a "bet" on ever-rising U.S. prosperity to be very close to a sure thing.** That has definitely been the case during their lifetimes. For whatever trouble the United States may have, the entrepreneurial, hard working spirit of this country has survived.

In a 2006 article with Kiplinger's, Charlie Munger said, *"The Berkshire-style investors tend to be less diversified than other people. The academics have done a terrible disservice to intelligent investors by glorifying the idea of diversification. Because I just think the whole concept is literally almost insane. It emphasizes feeling good about not having your investment results depart very much from average investment results."* In my opinion, what he is getting at here is that the more broadly a portfolio is diversified, the more likely it is to match the performances of the average. The more concentrated the portfolio, the more likely it will be to deviate from the average. Further, in 2014, Munger said, *"Practically everybody that I run across that has a very good record for a VERY LONG TIME, he doesn't do it by owning one hundred different securities over twenty different sub-sections of the economy. "* I completely agree with Mr. Munger here. There are many studies out there that show the average fund manager doesn't beat their benchmark. Logically, you should know that to be true since investing is a zero sum game. "Closet indexers" as they are called are managers whose holdings look incredibly like the index they are compared to. Conversely, truly "active" managers many times have more concentrated portfolios, with higher volatility but may be more likely to compound wealth at a higher rate over time. There will be times these managers underperform and times they outperform but one way to narrow down a search for outstanding portfolio managers is to find ones who "dare to be different".

Fitting this to a T, Warren Buffett's Chairman's letter from the Berkshire Annual Report in 1993 said, *"The strategy we've adopted precludes our following standard diversification dogma. Many pundits would therefore say the strategy must be riskier than that employed by more conventional investors. We disagree."* What this means to me is that Mr. Buffett and Mr. Munger believe that one cannot do better than the markets over time unless one operates a high conviction, concentrated portfolio. When choosing active managers to help create a portfolio, my general belief is to find managers

- With a consistent, defendable philosophy
- A history of compounding wealth
- Lower than average costs compared to their peers
- A more concentrated portfolio

Common Themes of Successful Investors

When looking back in history at many successful investors, while there are always outliers, I have found a few consistent themes. They are the following:

- Be aware that there were always be unknowns. Investing and speculating is at best an educated guess, because the future is unknowable.
- Think independently and be skeptical of conventional "wisdom".
- Avoid the waves of irrational behavior and emotion that periodically take over the markets. Such behavior can often lead to excessive prices, bubbles and eventually, permanent loss of capital.
- Invest in high return businesses. Cash flow is more difficult to "massage" than earnings. Companies that cannot earn positive free cash flow often are forced to raise new capital. Excess cash, when not used to improve profitability should be used to repurchase shares
- Even the world's greatest business is not a good investment if the price paid is too high. Price/Earnings ratios or its inverse, earnings yield can be a useful indicator for determining valuation.
- Invest for the longer term.
- Good investment ideas are hard to find. An investor is not likely to obtain superior results by investing in a broad cross section of the market. The more diversification, the more performance is likely to be average. If you are seeking average performance, invest in products that seek to replicate the performance of an index, as they may have lower fees.
- Observing correctly that the market was frequently efficient and rational, academics and some investment managers went on to conclude **INCORRECTLY (IMO),** that it was **always** efficient.
- The wise ones invest heavily when the world offers them opportunity (think blood in the streets). They bet big when others are cashing out and the rest of the time they don't.

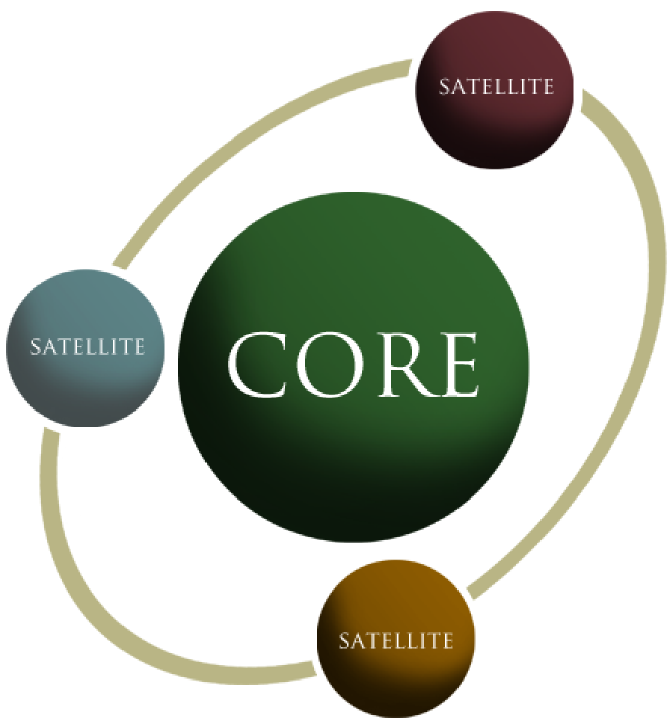
Value

In my opinion, if one is to outperform the market over time, "value stocks" can potentially help. By sticking to a more concentrated portfolio of securities with a value bias (25-50 in my opinion), one may have a potentially prolific portfolio but also one that may be too volatile for an individual investor to stomach on its own. As I have said repeatedly, the best investment strategy is one that you will follow through thick and thin. Even though many of the most successful long term investors are concentrated, most people will not be emotionally suited to investing in a concentrated way. Doing so requires confidence in the process, strategy and the judgement to follow it. Generally, I believe that better investment records are held by managers who are willing to bet against the herd. Not for the sake of being different, but because at excesses, the herd is often wrong.

Conclusion

In my opinion, a great way to take advantage of the thoughts and themes addressed in this newsletter is a two pronged approach. What I like to call a CORE-Satellite portfolio. Core strategies can either be passively managed or actively managed but the approach is to be broadly diversified globally, strive to manage taxes and expenses and have a bias toward undervaluation. This approach can provide a buffer during dislocations in the market and a potential margin of safety by favoring undervalued areas. Of course there isn't a holy grail and each strategy has its drawbacks.

By combining the portfolio core with more concentrated, value oriented equity strategies, one can potentially improve risk-adjusted returns. If you would like to learn more about implementing this approach feel free to reach out http://www.celestialwealthmanagement.com/ebooks/



Investment Ideas

- **Rather than trying to "beat the market", focus on beating inflation and the rate on cash. Plan for safety and liquidity while seeking positive returns.**
- Equity valuations are very rich but masked due to the distortion of the Treasury curve. Volatility is returning to the markets and I think long/short managers are best positioned to capture this volatility by owning companies with strong businesses, barriers to entry, and good valuations and selling short weaker companies with high debt loads that have risen sharply with the broad market rally. I think this strategy of <u>hedged equity may have the potential to produce attractive risk-adjusted returns</u> if and when investors begin to question the valuations of companies. Stock investing involves risk including loss of principal. No strategy ensures success or protects against a loss. Long positions may decline as short positions rise, thereby accelerating potential losses to the investor.

- Monsoon country investments. Attempting to take advantage of demographic, educational and investment possibilities in the countries surrounding the old spice routes of the Indian Ocean. International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. These risks are often heightened for investments in emerging markets.

- In 2013, the Affordable Care Act began implementation. There will be many winners and losers in the healthcare industry as a result of the biggest change in the healthcare industry's history and what the new administration decides to do with it. With the largest portion of the U.S. population entering their golden years, healthcare needs will become even more important. Long/short Healthcare seems to be a very attractive way to invest in a sector with lots of potential and lots of potential pitfalls. Investing in a specific sector involves additional risk and will be subject to greater volatility than investing more broadly.

- A potential U.S. infrastructure upgrade cycle may be around the corner. Moving from our current grade of D+ to B would require an investment of $3.6 trillion by 2020.

- Supply problems remain high across the energy asset class. While there isn't a current shortage of energy on the planet, it is taking more and more energy and capital to discover, drill, transport and refine it. Long term Demand should continue to grow globally, particularly in China, India, and other developing countries.

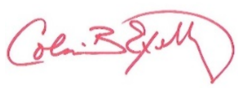
- Potential food shortages due to inclement weather and higher demand from the emerging Asian middle class could result in a boon to agricultural land and potash fertilizer companies. International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

- The rise of E-Commerce has coincided with an increased desire for efficient warehouse distribution real estate. As e-commerce moves toward even faster delivery, positioning of distribution becomes even more important.

- Precious metals mining companies have been extremely beaten down over the past four years but have begun rising. Mining is an industry that spans hundreds of years. Companies that mine for commodities are often highly cyclical, meaning they have sustained moves both up and down. When investing in the mining space it is important to be a contrarian. Ideally, you would want to accumulate miners when sentiment is poor around them and sell them when sentiment is positive. Historically this has been a good strategy.

  No strategy ensures success or protects against a loss.

Regards,



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