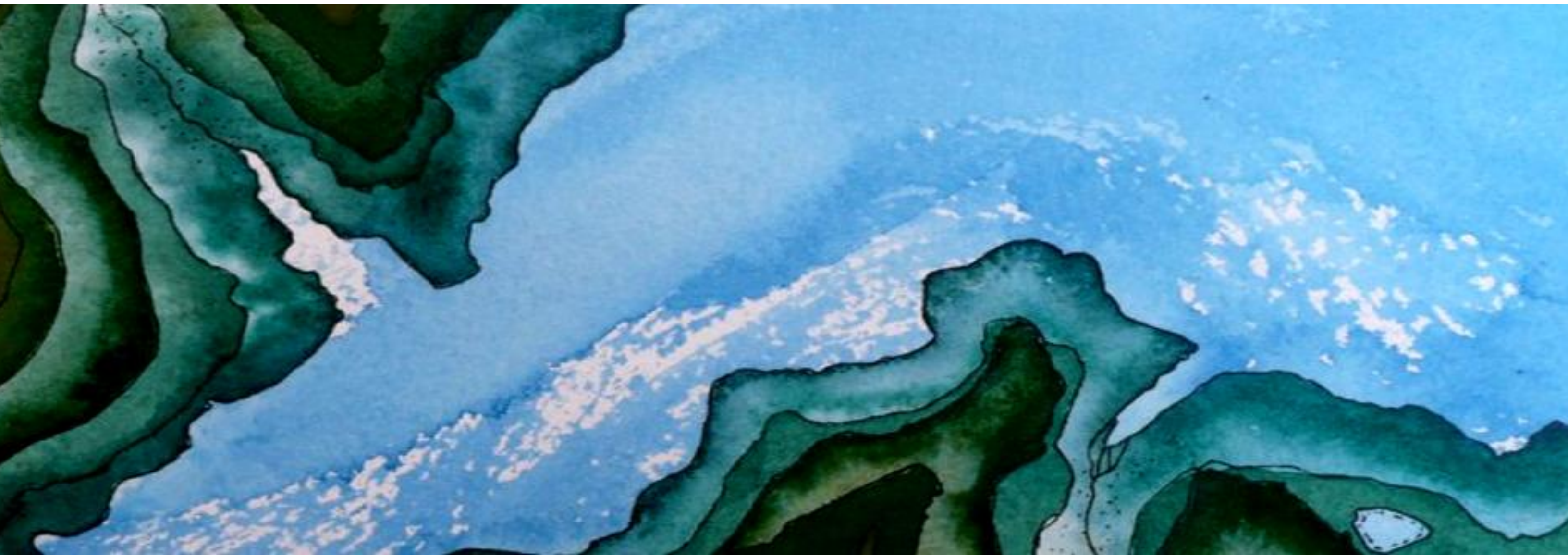


Coastal Detail, Courtesy *Molly Holmberg Brown* – www.*mollymaps.com*

A Peaceful Cliffside

Cartographers rely on a range of tools to make the complex topography around us more understandable. Similarly, investment analysts use their skills to navigate the abstract terrain of finance. In both activities tension arises because the caricatures we construct can't capture the full complexity of the space around us. The real value of these "models" is their ability to highlight the features we deem worthy of attention.

Our map of global markets worked well for us in 2012. By the end of Q3 many of our investments had performed beyond our annualized expectations for them, and then Q4 brought a much awaited "Asian recovery" lifting our previously lagging Asian positions sharply. Equities were the asset class of choice. This leaves us in good position for 2013. We know roughly where we are in terms of global flows, and are better provisioned than when we started.

So what complexities lie ahead?

First, the last minute deal making around the *fiscal cliff* leaves a lot of unanswered questions. The obvious problem with rushed policymaking is that it leaves everyone doubtful of the quality of the results. While this heavily watered down legislation represents a short-term win for the economy, it does little to address the longer-term problems the sequester trigger was created to confront—the deficit and national debt. That means plenty of uncertainty remains.

Perhaps worse, the political theatre brought the horrendously complex state of the tax code to our attention and raised hopes that action would be taken to address it. In the end, we saw only increases in a few top-end tax rates and the expiration of payroll related stimulus. In lieu of any real action, we now have the pleasure of waiting until February to see renewed threats of a government shutdown. *Déjà vu* anyone*?*

Fortunately, the hubbub presents an opportunity to discuss a couple features of the new landscape that have unique importance to our strategy. Since you're already warmed up on taxes, I will start there.

Taxes are pretty well known waypoints on our map, and thus tempting to make investment decisions by. But other factors ultimately drive the majority of after-tax returns. It's critical we focus our attention where the most value is. This point was put into stark relief in mid-December when a big sell-off in municipal bonds materialized on rumors of tax exemption changes. Higher income investors need to do the math on these bonds because they can often save money on taxes. But the simple calculation we use to find out which bonds will result in a better after-tax yield creates false confidence. It doesn't do justice to key considerations like the actual credit-worthiness of the bond issuers themselves, or the risk premiums built into their relative yields.

The action in municipal bonds was comical. New assets flowed into the bonds all year ostensibly seeking shelter from the coming tax increases. Then discussion emerged that the bonds might be stripped of these tax benefits and money quickly began to flow right out in the opposite direction. Investors were left holding very volatile investments relative to their yields. The lesson, which applies to all tax-deferral strategies, retirement accounts, 529 plans etc., is that risk lies in the assumption that policy is static. Our decisions should always strike a thoughtful balance between asset quality and policy related factors.

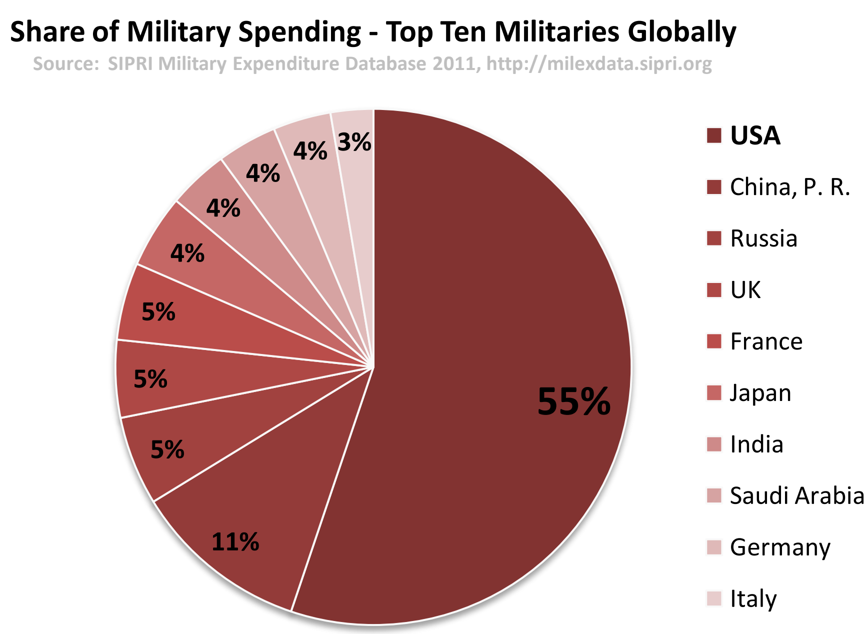
That said, one part of the tax code does have special importance to our investment strategy, and it deserves your attention. That feature is the spread between top income tax rates and long-term capital gains rates. As you know, equities investors grapple with three primary taxes: short-term capital gains, long-term capital gains, and qualified dividend tax. Given that most clients are in income tax brackets approximately double the 15% (or for some now 20%) rates on long-term capital gains and dividends, we generally avoid spending too much time looking for short-term gains because those gains are taxed on par with normal income. This differential in tax treatment is enough to undermine a considerable part of any edge we might see in most short-term trading ideas. Our approach, instead, utilizes the built-in tax deferral features of long-term equity investing. Clients need to understand that our strategy has more exposure to the spread between capital gains rates and income tax rates than it does to nominal tax rates. While paying higher rates will cost us a bit on the margin, they will not in and of themselves undermine our strategy's efficiency.

In short, while investment tax rates did increase for some, the spread in question did not change meaningfully under the current resolution. That's a good outcome for our strategy, though not ideal. It was my hope that Congress would add stability to financial markets by letting that spread expand a bit (thus reducing the attraction of short-term trading) and limit loopholes and deductions instead. That would have been a decisive win for us at the expense of special interests and casino finance culture.

But enough on taxes. Let discuss Peace & the New Year.

We all get holiday cards wishing us peace in the coming season. Strangely, the lack of agreement on the fiscal cliff almost brought us some peace this year in the form of significant defense spending cuts. Before I get into this potentially controversial subject, I want to disclose a couple things. First, the Sankala Group supports a number of clients who avoid defense specific investments. Second, this viewpoint's investment merit has been reinforced by the underperformance of the *Dow Jones Aerospace and Defense Index* against the S&P 500 in 2012. I've gone far enough with my analysis to believe this investment stance will not only satisfy these clients personally, but it will also likely be a driver of relative performance over the coming decade. I make these statements as clearly as possible because it's always sticky making an argument for what you want to see in the world on investment related grounds.

Some third-party observers believe that 2012 was the first year in United States history where military spending (inclusive of domestic security spending and associated interest payments) broke the trillion dollar barrier. $1.03 trillion USD to be exact[i]. Surprisingly, despite this incredible expense, defense cuts remain more taboo in Washington than entitlement spending cuts. As investors we can't afford to wear these same blinders:

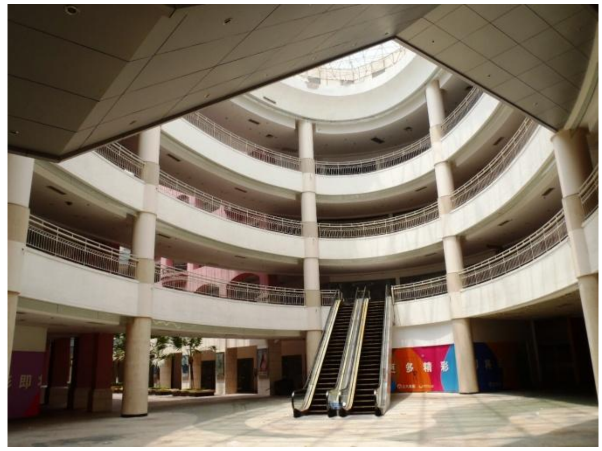


As you can see, China, which has four times as many people as the United States, spends 1/5th of what we spend on their military. The quick math here reveals that per capita, the U.S. spent ~$2155 USD on the military in 2011, while China spent about ~$107 USD per capita, or ~1/20th as much per person.[ii] Interestingly enough, in 2011 U.S. *per capita military spending* (~$2155 USD) didn't surpass Chinese *per capita income* (~$3493 USD.) Please re-read that last sentence slowly. The fact that it's even close is startling.

So why is this information important? Because you don't hear people talk about U.S. military spending in terms of a financial bubble—and perhaps you should. Let's compare it to our media's favorite bubble, the bubble that won't burst in Chinese real-estate and infrastructure. In late 2009, 2010, and 2011 China unleashed considerable financial support for domestic construction. As expected, some of these loans have gone bad. The *China Banking Regulatory Commission* estimates the bad loans in the system are ~100 billion USD. Given that everyone knows CPC numbers are suspect, lets up that by a conservative 3-fold to be safe and call the sinkhole 300 billion USD deep. This entire *multi-year* pile of bad loans on China real estate and infrastructure could be settled with what we have spent on our military since roughly mid-September.

Of course spending does result in some new assets getting added to the balance sheet, so let's take a closer look at the asset quality. One of the big ticket items in the U.S. defense budget is the Lockheed Martin F-35 Lightning Joint Strike Fighter. At an estimated research and development included "fly-away" cost of $303 million USD[iii] per single-seat, single-engine plane, the U.S. is expecting to buy fully 2,442 of them over the coming years. I was unable to find flight hours data for the current fleet, but have to guess that each plane will sit grounded a fair amount of the time, simply deterring others from bothering us. That might be a good thing because its Pratt & Whitney engine, with 50,000 lbf of thrust, burns a lot of expensive top-grade fuel. And given that 4 of them have already been aborted in test flights[iv], we don't expect them to land in one piece anywhere near as often as your average jetliner.

In comparison, the still-as-yet empty real estate developments in some parts of China seem pretty manageable in terms of cost. $303 million dollars still goes a *very* long way towards building a world-class "ghost mall" in China. While somewhat tongue in cheek, the point is real. We simply don't need and can't afford to buy 2,442 single seat airplanes costing more than a quarter billion dollars apiece when we are already so much better armed than those around us. In response to the F-35 project's amazing cost run-ups, Robert Gates, our previous Secretary of Defense, said "The culture of endless money that has taken hold must be replaced by a culture of restraint." Dwight Eisenhower, who warned Americans in 1960 about the potential for the defense sector to co-opt the economy and politics, must be rolling in his grave. The pictures and captions below will help you visualize my comparison better.



Left: Five F-35's under construction, estimated cost 1.52 billion USD. ***Right:*** The New South China Mall, the world's largest mall sits unoccupied. While the final cost of the mall is still unknown, we do know it would cost nearly twice as much to crash a single F-35 as it would to bail-out the developer's outstanding loan of ~154 million USD from Agricultural Bank of China.

While we obviously shouldn't brandy around the word "bubble," as investors we need to evaluate industry supply and demand and be particularly mindful to avoid gluts of inventory and overbuilt capacity. Both conditions tend to result in very poor investment returns. In my view, the U.S. military appears to be nearing the end of period of peak demand. The defense sector outperformed the broad market significantly during the 2000's on the back of seemingly endless government credit and multiple foreign wars. The frenzy is now winding down. The wars are being halted and the U.S. Treasury doesn't have much treasure left to burn. Some of the order backlog touted by defense contractors (Lockheed Martin Corp. reports an order backlog almost 2.5 times its current market capitalization) could well turn out to be "ghost backlog." Additionally, the fact that sizable defense cuts were built into the original sequestration shows that beltway insiders are aware that weapons spending has gotten out of hand. Be assured the subject will be back on the radar come February's debt-ceiling discussions. You don't need to take my word for it. Industry insiders are best aware of the risk:

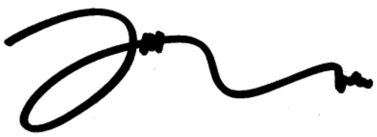
"We are concerned that we still face the possibility of U.S. budget sequestration in January 2013. Sequestration would result in an additional $1.2 trillion in automatic across-the board cuts evenly divided between defense and non-defense spending over 10 years. Coupled with the $487 billion already cut from the budget, sequestration would result in almost a trillion-dollar reduction in defense spending over the next decade. Secretary Panetta has said that cuts of that magnitude would have catastrophic consequences to U.S. defense and would severely erode America's industrial base. We agree. We must not let an automatic budget trigger become the dominant force for allocating resources and shaping the nation's security posture." *–Robert J. Stevens, Chairman & CEO, Lockheed Martin Corp. Annual Report 2011*

The clear issue is that our nation's "security posture" is taking a serious toll on our more fragile financial posture. The levels of government spending to which these contractors have grown accustom is deserving of your attention. It's a meaningful part of our current economic output, and it's likely the sector's allocation of government resources will be limited by the requirements of more pressing domestic priorities.

In closing, I don't think it is only a lack of funds that may lead us into a period of relative peace. Just as important, the United States is now closer to energy independence than we ever dreamed possible a few years ago during the peak oil mania. Our domestic energy business has started to reduce our reliance on foreign oil, which is in turn starting to help reduce the trade deficit and lift demand for the dollar. As the United States grows more secure in this regard hopefully we will find ourselves less involved militarily in other nations.

On that optimistic note, please take a moment to enjoy the image below. I found it while researching the defense budget. It was created using the latest NASA technology, and is a fittingly reflective perspective on the dynamic world we're entering in 2013:

Wishing you all the best in the New Year,



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[i] Federal Government Outlays by Function and Subfunction: 1962–2015 Fiscal Year 2011 (Table 3.2)
[ii] SIPRI Military Expenditure Database 2011, http://milexdata.sipri.org
[iii] February 2011 Pentagon estimates for the 2012 production vintage, RDT&E spending included.
[iv] Secretary of Defense Internal Memo - J. Michael Gilmore, Pentagon Weapons Testing