

**CROWELL WEEDON ASSET MANAGEMENT  
MONTECITO INVESTMENT PORTFOLIOS**

January 1, 2015

Dear Fellow Investors,

We've outlined the major topics & takeaways of this year's letter in an easy to follow format. Those sections are:

***Main Message Highlights***

***Lifecycle of an Investment***

- Deep Value, Value, GARP, Growth and Momentum Explained
- Where we see the markets in the Lifecycle of the Market as a whole
- How we position ourselves.

***Forecasts for 2014*** – As forecasting goes we did pretty well with 7 out of 10 correct. One of the forecasts we missed on was oh so close and the two other that we missed frankly we are glad we did! We will reiterate that these forecasts are our thoughts at the time we write them, and they can and do change as events unfold, but we are putting them in print and don't shy away from making forecasts we can be held accountable to.

***Thoughts & Forecasts for 2015*** – Never learning our lesson we will forecast the future once again!

***Core Forecasts for 2015***

- U.S. Economy expands at a GDP Growth rate greater than 3%
- 10 year treasury drifts higher, but stays below 3.5%
- Federal Reserve's discount rate stays below 100 basis points
- S&P 500 ends 2015 up and extends the multi-year trend finishing up over 5%
- Health Care and Self-Storage lead in the real estate sector
- Residential real estate prices increase by approximately 5%
- Inflation remains relatively benign at lower than 3%

***Additional Forecasts for 2015***

- West Texas Oil trades back into the \$60's and may spike above \$70 during 2015
- Republican Senate passes a bill to lower taxes on repatriated corporate cash.
- Infrastructure investment in Africa gathers significant momentum

***Closing Comments and Thanks***

- Try to pay attention to the obvious
- Where is my income going to come from – pre-announcing white paper on income in retirement and asset allocation

## MAIN MESSAGE FOR 2015 & BEYOND

- **LIFECYCLE OF AN INVESTMENT – DEEP VALUE, VALUE, GROWTH AT A REASONABLE PRICE (GARP), GROWTH, MOMENTUM**

Successful investing is part science & art. There is no instruction manual on how to successfully invest, there is no crystal ball that predicts the future of stock prices, and there isn't one magical formula that only spits out stock market winners. Successful investing takes discipline, skill, knowledge, patience, & the ability to separate emotions from decision making.

With that said, there are some broad categories of investing styles that have been used in an attempt to achieve success. We thought it would be valuable to explore the characteristics of each investing style and also see how individual stocks & even entire markets can transition from one style to another over market cycles. This is done with the hope that we can identify where we are today.

The broad styles we would like to explore are:

- DEEP VALUE
- VALUE
- GROWTH AT A REASONABLE PRICE (GARP)
- GROWTH
- MOMENTUM

### ***DEEP VALUE: Rolling the dice on survivability***

A deep value investor likes to troll through the dregs of the stock market shopping for bargains. It is often not pretty. Certainly if things are trading at pennies on the dollar, then "smart money" must know it is one step away from being worthless. The deep value investment may be on the verge of bankruptcy. Sometimes this is the case but occasionally the Phoenix can rise from the ashes, or there are assets that are not being valued even at liquidation prices. At any moment the road back can dead end and the investment thesis unravels. An investment in these companies can take an immense amount of specialized knowledge, fortitude, and patience to work out.

Characteristics of deep value stocks include:

- Trading at low or no multiples of earnings & sales – may be losing money.
- Does not have free cash flow that can pay dividends
- Stock price is down significantly or has grossly underperformed the rest of the market
- Future business prospects look bleak
- Wall Street analysts have "thrown in the towel" and dropped coverage or rate a "sell"

### ***VALUE: The Market's Bargain Shoppers***

A value investor will look at those companies that have fallen on hard times and their prices reflect a serious lack of confidence in the future for the company. After all, if you can buy something at a bargain price you normally assume it is of lesser quality or something is wrong with it. But, with research and investigation you may find that things have changed or there are assets that are worth more than the price of the stock. After all, who doesn't like buying a dollar for 50 cents? When value investing works, you pick up a piece of a quality business at a rock-bottom, wished for price.

Characteristics of value stocks include:

- Trading at low multiples of earnings & sales
- Has a high dividend yield, or is just about to restart a dividend payout
- Stock price is down significantly or grossly underperformed the rest of the market
- Future business prospects have serious questions to be answered

The characteristics of value investing probably sound a little depressing. Why would we want to invest in a struggling business that hasn't seen its stock price go anywhere? The answer is primarily driven by the cheap price we are paying. With Wall Street's quarter-to-quarter obsessiveness and instantaneous media coverage a struggling company can quickly fall into the underbelly of the market. These companies can stay here for extended periods of time, out of favor, lacking respect, & offering substantial discounts to the true worth of the business. Under appreciated and under loved while all the time turning around their business prospects.

***GROWTH AT A REASONABLE PRICE (GARP): Trying to get the most bang for the buck***

GARP investors are looking for quality companies expected to continue to grow at above market rates. However, just because the company is expected to grow a GARP investor doesn't want to pay a fortune for it. We liken GARP investors to Corvette buyers. The 2015 Chevrolet Corvette Z06 sports a sub 3 second 0 – 60 MPH time & sub 11 second ¼ mile time. Impressive performance by any measure, but even more attractive when you compare the price of a new Z06 (approx. \$80,000) to other vehicles with similar performance. Similar performance from a Nissan GT-R will cost you about \$103,000, \$180,000 for a Lamborghini Gallardo, \$1.5 million for a Ferrari 599XX, & \$1.2 million for a McLaren P1.

GARP investors are OK with paying a fair value to own a piece of a high quality company. They will assign value to both the current earnings and future earnings of an established franchise.

Characteristics of GARP stocks include:

- Often trade at slight premium earnings & sales multiples when compared to the market or peers within their industry
- Leading market position within their industry
- Pays a dividend although the yield may be below market averages
- Stock price tends to hold up very well in times of weakness due to a "flight to quality"
- Future business prospects look promising

***GROWTH: Validation every quarter!***

Growth investors focus primarily on finding those companies producing above average growth rates. Earnings & sales multiples don't matter much for a growth investor as long as the growth story continues to unfold, they remain confident they will make money. Often times, these growth investors focus on the exciting areas of the market. Today, we could look at social media, biotechnology, 3D printing, just to name a few, as the hot sectors of the market where many companies are delivering double digit growth rates quarter after quarter, and importantly, guiding to good performance in the future as well.

Characteristics of Growth stocks include:

- Trade at earnings & sales multiples that value investors would describe as ludicrous
- Are often in the early stage of their corporate lives
- Most do not pay dividends as they feel they have better uses for any internally generated cash flow
- May not generate positive cash flow
- Usually have a great story as to why you have to own a piece of this company

***MOMENTUM: The Crowd at its best!***

Momentum investors focus mainly on direction. If something is going up, momentum investors will ride that uptrend until something changes. What a company does, its value, who's running it, are not of major concern, other than as justification for getting on the bandwagon. What is important to momentum investors is that a stock is moving and that they own it while it is. Momentum investors usually jump in as a company is making new highs & may even short as a company is making new

lows. They can take a well performing stock into the stratosphere or drop a company going through rough times into the doldrums as if it were going under. And when the momentum music stops, they don't just leave the dance floor, they run for the exits.

Characteristics of Momentum stocks include:

- Big price movements in either positive or negative directions
- Often seen near tops or bottoms of price moves
- Not focused on fundamentals of the business
- Often cause other market participants to jump in when they see the big price moves

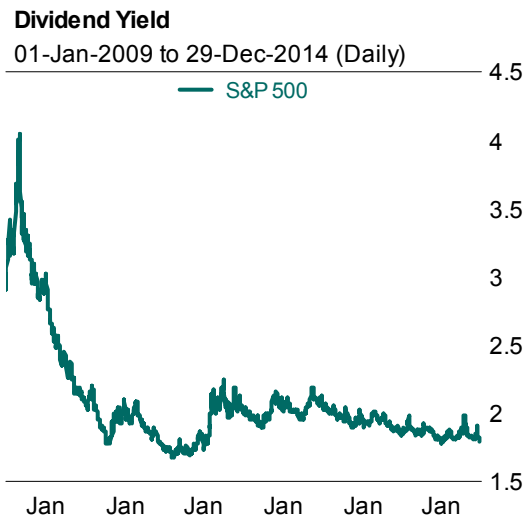
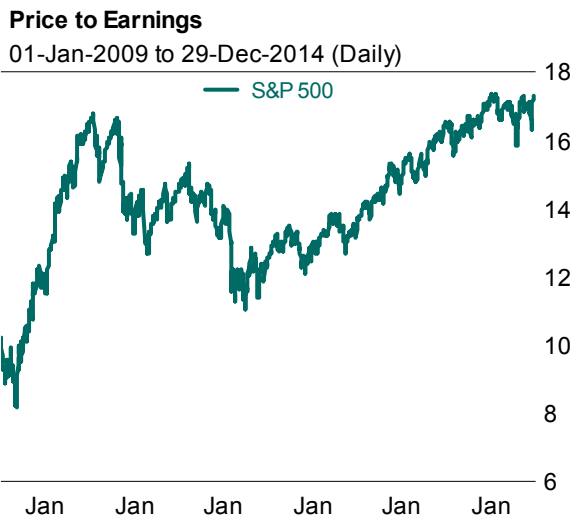
**LIFECYCLE OF AN INVESTMENT: *Why is it important?***

We wanted to explore the lifecycle of an investment this year because questions are surfacing about the valuation of the market. With the major indexes nearing or at all-time highs, are we overvalued? If we are not overvalued, where do we invest?

Traditionally the Deep Value investors will be the buyers at the lowest prices. They are willing to invest at low prices because expectations are so low that any improvement can lead to higher prices, and if the company fails it may be worth more in liquidation than as a going concern. Once the investment thesis develops, both GARP and Growth investors will be the buyers from the Value investors. The value investors now see more liquidation risk and higher volatility and are willing to move into other companies with greater "value", the growth investors take on the volatility for better vision as to the future of the company. Then as the results improve and the company is recognized, the momentum investors are, typically, the last ones in, buying from the growth investors who can no longer justify the valuation metrics. The phases of the market are very similar to the phases of investors in an individual company.

We primarily manage portfolios from the bottom-up - meaning we look at each individual company as a stand-alone investment. However, we do monitor many metrics in regards to the overall valuation of the market.

We are pleased to report that although market indexes may be hitting all-time highs, valuations still remain reasonable. Taking a look at some valuation metrics paints a nice picture about the US stock market as measured by the S&P 500 Index:

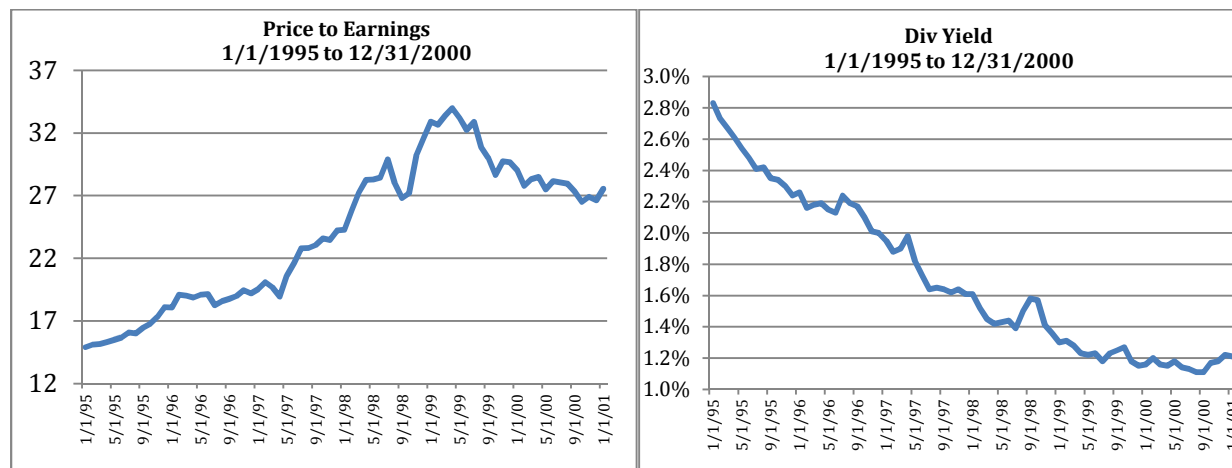


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Source: Factset 1-1-09 to 12-29-14

As you can see the Deep Value phase of the market was back in March 2009 when there was fear of financial catastrophe. The market traded at nearly 8 times earnings and yielded about 4%. In our opinion, over the past 6 years we've transitioned from the Deep Value to Value to the GARP stage of the investment lifecycle. We are seeing some signs of entering the Growth stage but fortunately, do not yet see signs of the Momentum stage for the market as a whole. We say fortunately, because as you transition from one stage to the other, risk and volatility changes. For comparison, we can look at the last time we feel the market was truly in a Momentum phase – late 1990's.



Source: Factset 1-1-95 to 12-31-00

A few items of observation – in the Momentum phase valuations can remain elevated for years and even accelerate towards the end. The P/E ratio of the market went from a near historic average of 15 in 1995 to over 33 by 1999. Also, the Dividend Yield of the index fell from 2.8% to just above 1% during 2000. It took many years for the market to recover from some of these super elevated valuation levels. This is why we say fortunately, because we do not see this type of behavior in today's market.

**LIFECYCLE OF AN INVESTMENT: *The Game plan***

Now that we've recognized the lifecycle of an investment we want to capitalize on it as well. Ideally, the way to do so would be as follows:

- **Discovery** - Find a quality business that is extremely out of favor in the market for reasons that we feel are short-term in nature and not something fundamentally wrong with the business. In fact, the internal economics of the company may be improving and showing the foundations of future growth. This is where we will find the Deep Value / Value stage prices.

- **Be Patient!** – For a company to emerge from the stock market doldrums it may take quite a bit of time. CEOs may be replaced, business restructuring might take place, etc. These things can take time.
- **Check Progress** – While patience is essential, so too are results. If a company is to get out of the Deep Value / Value range they must start showing some type of promising results. Know the thesis and how long it should take to work out.
- **Successful Progress** - Once the company shows proof they are growing and the thesis makes sense to investors for the long term, the GARP investors will start to accumulate shares.
- **Exposure** - With proven success, Wall Street analysts will start to raise estimates believing the worst is behind & better days are ahead. At this point we've entered Growth stage.
- **Everybody Loves a Winner** - Seeing a company turn itself around and shareholders be rewarded with great returns Momentum begins to take hold. Traders enter the stock taking advantage of many average investors buying what has worked in the past. This is when valuations can become irrational (remember those dot-com days?).

Risk & Volatility tends to increase as you move through the Investment Lifecycle. Eventually, the price you are paying for an investment becomes the main component for future returns. This is why we tend to focus on the earlier stages of the Lifecycle. If we had to categorize ourselves in a particular style we most likely fall in the late Value to GARP range. We attempt to buy great businesses at good prices while also thinking contrarian to the general market consensus. The challenge as investors of any type is to step outside your comfort zone to potentially maximize returns. Finding a value stock & holding it through the lifecycle to eventually sell to the momentum crowd is easier said than done. What is comfortable for a growth investor makes a value investor cringe. We believe recognizing these tendencies helps lead to better investment returns.

## FORECASTS

This is the section of the annual letter that most readers turn to first – that foolish section where we actually make forecasts for the future! We enjoy this process of using “What If” in our thought process as it allows us to think outside of the box and challenge our (and your) assumptions. Much like our health, checkups are single points in time and we may have to adjust things in the future if we get sick in between check-ups, these forecasts are our thoughts as of the writing of this annual letter.

We remind everyone our portfolios are managed substantially from the bottom up – meaning, we look at individual investments themselves and the long-term value they represent, knowing that quality companies at the right price represent value. With this reminder out of the way let us review our forecasts from 2014's annual letter and make some new and bold (and perhaps foolish given our longer term perspective) forecasts for 2015.

First, let us check and see how we did last year.

## 2014 FORECASTS

- **US Economy** – “ObamaCare” adjustment pains, midterm elections, and debt ceiling debates impact consumer confidence. Tapering takes some liquidity that was driving economic momentum – **GDP for full year positive +/- 3% range**
  - *The first quarter slowed GDP growth substantially with the “Polar Vortex”, and in fact the economy contracted by 2.1%. But, according to the BEA (Bureau of Economic Analysis) the 2<sup>nd</sup> quarter growth was 4.6% and third quarter was 5.0%. The 4<sup>th</sup> quarter statistics are not released yet, but there is general agreement that there is positive momentum in the economy as the employment rate continues to drop and retail spending is growing. Averaging in with the decline in the first quarter we will be very close to the 3% number predicted for 2014 – **full point.***

- **Fixed Income** – Long-term bottom established in 2013 at sub 2% on the 10 year Treasury. As the Fed tapers their purchases of bonds and the economy has some positive growth and corporations come to market with yet another record issuance to lock in these rates, **we see the 10 year Treasury drifting to higher yields but do not expect it to end above 4%**. Although if it does it means the economy is doing better than we anticipated.
  - *If anything the yield on the 10-year drifted sideways to lower. We were correct that corporations continued to lock in these low yields with a significant amount of bond issuance. While we were also correct that the economy is improving, unemployment is down, and inflation is subdued – all of which would allow for less accommodative rates - the worldwide economy continued to be weak and the safety of the dollar saw flows into US Gov. Securities. Those influences, and a cautious Federal Reserve, kept rates in check – **No Point here***
- **Federal Reserve Discount Rate will stay below 50 basis points** as the stimulative bond buying needs to be completely undone before they raise rates again. Last year's \$85 Billion a month buying rate will be tapered back but we think with the adjustments to the economy mandated by the gridlock in Washington and economic adjustments to the realities of "ObamaCare", we feel it will take the full year to possibly back away from the stimulative buying completely.
  - *The Federal Reserve has completed their open market bond purchases, but has kept the discount rate at 0 to 25 basis points. We hit this one exactly – **full point***
- **US Equity Markets** – The trend of corporate balance sheet restructuring with buybacks of stock funded by debt issuance at low rates will continue. The non-financial companies in the S&P 500 have over \$1.5 Trillion dollars on their balance sheets that can be used to enhance shareholder returns. At year end the dividend payout of the S&P 500 was close to 33% versus a normal 50% over the long term. The trend of activist shareholders looking to restructure balance sheets will continue into 2014. At the end of 2014 the market will be selling on 2015 expected earnings that consensus presently has at \$133. If it sells at the present multiple of 15 times forward earnings then it would imply an upside target of 1,995. With an expanding economy the psychological perception of value will allow for some PE expansion. So **we are looking for a target in excess of 2,000 for the S&P 500 for year end 2014 – up over 10% for the year.**
  - *The S&P 500 closed the year at 2,059 points. With almost all of 2014 in, 2014 earnings for the S&P 500 look like they will come in at approximately \$127.50 – less than the anticipated \$133. However, with the better economic environment at the end of the year, the PE ratio expanded a bit more than we anticipated so we came in right at our forecast for the year – **full point.***
- **Commercial Real Estate – Industrial space will continue to be the leading space.** Apartments are ending the year 2013 at very high prices and could see some under-performance relative to other commercial sectors. **Manufactured housing communities outperform** as their low cost of entry makes sense when compared to paying after tax rent.
  - *According to REIT.Com through the End of November 2014 Residential REITs outperformed all other sectors – up 37.64% and within that group the best performing were Manufactured Housing at up 40.50. – **Full Point***
- **Residential Real Estate** will face two headwinds during the year. The first is mortgage rates ticking up a bit. The Federal Reserve's bond buying program has been centered in the mortgage-backed space. As they are no longer absorbing as many securitized mortgages, rates may need to increase a bit to find other investors. Second we believe that the shadow

inventory of bank held properties and delayed foreclosures will continue to make their way into the market creating supply. The record settlements the large banks have been making with regulators are clearing some of the last hurdles to their more aggressive cleansing of their loan portfolios. We see the millennial's and echo boomers providing the demand for housing, but at the lower price points. **Low-end Residential Real Estate may rise by 5% in 2014.**

- *Mortgage rates did not tick up in 2014- however; mortgage qualification is still an issue as banks continue to have very strict underwriting requirements. Super high end properties were being discounted Millions of Dollars just to get any interest at all. And second home prices have shown declines in many areas of the country. Primary home prices have shown some steady increase with the Federal Housing Finance Agency's US house price index rising 4.58% year over year in Q3 2014 and the widely followed S&P Case Shiller national home price index up 4.81% through the 3q 2014.. First time homebuyers dropped from 38% to 33% of the purchasers and over 1/3 of adults in the country are now living with relatives or roommates, as compared to just 27.4% in 2006 according to Zillow. – **Full point***
- **Inflation** will remain benign in 2014. The Federal Reserve is sending a message that the deflation battle may be won for the moment, or else they would continue with the stimulative bond buying and the expansion of the money supply that is its byproduct. The economy will be coming to grips with higher medical insurance costs and expected higher interest rates into the future and we certainly could see pricing increases attempted in many industries this year. As inflation generally is like a supertanker that cannot change direction very quickly, we see 2014 as a year where inflation may become a topic of discussion, but not an economic reality. **Inflation in the 3% range for the year.**
  - *Our expectation that inflation would rise from the 2013 levels of 1.5% were barely realized with the annual rate in 2014 coming in at approximately 1.88% through October. Returning to the more traditional 3% rate of inflation for the US did not happen. While that can be considered healthy for a recovering economy and allows the accommodative interest rates to continue by the Federal Reserve, we got this one wrong. **No point***

Last year, as in previous years, we have a few out of the box forecasts. They serve to point to issues and topics that normally might not be top of mind, but underlying them may have significant influences to the world we live in – or are just plain fun!

- **Antarctica will see the largest ice flow in history break away and global warming will become a forefront issue once again.**
  - *After an iceberg the size of Chicago broke off in July 2013 from the Pine Island Glacier, NASA has reported in May of 2014 that the collapse of the western ice-sheets of Thwaites Glacier and others is “unstoppable”. While it may take longer than our lifetime for the whole of the Glacier to breakaway, Chunks of this mass, that is larger than the Greenland Ice-sheet, break off regularly. And while sea ice is expanding, it is thinner and melts away every year removing the “brake” to the Glaciers finding their way into the ocean. In aggregate these chunks are greater every year. We write about this here to bring attention to the fact that the earth is going through a warming trend which is undeniable. Is man accelerating it with our use of fossil fuels and release of massive amounts of CO2 into the atmosphere is a question we will leave to the scientists. But the debate is taking the forefront again as the agreement signed by President Obama and Chinese President Xi Jinping on November 14<sup>th</sup> to reduce CO2 emissions shows. – We will take **a point** for this one based on the overall shrinkage of the glaciers and the signing of the agreement.*

- ***The Keystone Pipeline will finally get approval and start being built***
  - *Oh so close. We thought there might be one more major effort to get approval this last year. With the midterm elections a rout for the Republicans there was a run-off election in Louisiana. The incumbent Senator made a last ditch effort to get Keystone approved to help her reelection bid. It failed to get the 60 votes needed by just one vote. An “A” for effort, but **no point**.*
  
- ***For the first year in many years the Chinese Yuan will not appreciate versus the US Dollar***
  - *In 2005 the exchange rate was fixed by the Chinese government at 8.27 Yuan to the dollar. It was allowed to start to float in a controlled manner since then with the rate dropping at each year end as follows: 2005 – 8.27, 2006 – 7.82, 2007 – 7.30, 2008 – 6.84, 2009 – 6.82, 2010 – 6.60, 2011 – 6.29, 2012 – 6.23, 2013 – 6.05. So going into 2014 we stepped out against the 8 year consecutive trend to say that the slowing we saw in China, the transition from an export economy to a consumer economy, the obvious overbuilding slowing some development, would cause the Yuan to change direction. And as of December 29<sup>th</sup> the exchange rate was 6.22 – a clear change of direction – **full point***

## 2015 FORECASTS

- ***US Economy*** – Much of the recovery in the United States for the last 4 to 5 years has been due to the energy industry. Without that growth the rest of our economy compares to the rather lackluster growth being experienced in Europe. Yes the price of oil dropping as much as it has in late 2014 will impact investment in the energy area and impact jobs and growth. The drop of oil prices has led to a stimulus effect as consumers have more in their pockets after filling up their car, but the wild card to the economy this year will be the energy industry. We think the robust pace of growth we experienced after the “Polar Vortex” will moderate a bit. – ***GDP for full year positive +/- 3% range***
  
- ***Fixed Income*** – We are basically going to repeat our thoughts for 2014 - Long-term bottom established in 2013 at sub 2% on the 10 year Treasury. As the Fed tapers their purchases of bonds and the economy has some positive growth and corporations come to market with yet another record issuance to lock in these rates, ***we see the 10 year Treasury drifting to higher yields but do not expect it to end above 3.5%***. Although if it does, it should mean the economy is doing better than we anticipated.
  
- ***Federal Reserve Discount Rate will stay below 100 basis points*** – The open market purchases have ceased. The Headline Unemployment rate is down to under 6% and Inflation is sub 2%. In a perfect world the Fed would be able to remove all accommodative policies and have the Fed Funds rate be closer to a neutral rate of 1.5 to 2%. But it is not a perfect world. Many of the jobs that have been added are ‘permanent part time’. “Obama Care” taxes are kicking in and the shock of them will be felt as 2014 tax returns are prepared and filed. The worldwide economic picture is not as robust as the United States and could have a moderating impact on our economy. The economy is still “fragile” and the last thing the Fed wants to do is to stall a recovering economy. We see the language changing in the Fed statements and a strong desire for them to begin the slow process of raising the discount rate before the end of the year. However, we see the rate staying accommodative and below 1% by the end of 2015.
  
- ***US Equity Markets*** – The trend of corporate balance sheet restructuring with buybacks of stock funded by debt issuance at low rates should continue until the Fed begins raising the discount rate or until corporate boards feel the cost of the equity they are buying back is too expensive or they finally begin to invest in plant and equipment to expand. The energy

sector will continue to be the focus of investors due to its wide reaching political and economic impacts. With the US producers pulling back on development budgets due to the lower prices we see supply coming more in balance with demand in 2015. That stability will allow the markets to focus on forward earnings toward the end of the year. At the end of 2015 we anticipate the market will be selling on anticipated 2016 earnings of \$142. Applying a rather neutral PE multiple of 15 on those 2016 estimates gets us to a minimum S&P 500 target of 2130. Frankly while the worldwide growth situation stabilizes we feel there will be pressure on PE expansion, being in the GARP or Growth stage in the “Life Cycle of the market” could lead to some PE expansion that would see a forward price to earnings ratio of 16 to 17, or S&P 500 levels of 2272 to 2414 by year end 2015. So there is potential upside to our target with any worldwide economic recovery. We also are forecasting that sometime during the year there will be some “Black Swan” event (Much like Ebola in 2014) that may lead to the long anticipated 10% or greater correction. While we have experienced a number of 4% or greater corrections, it has been since March 2009 since the last correction of 10%. We are longer term investors though and do not recommend stepping aside to wait for such a correction, as it may start from higher levels than we are at today. For the year we are forecasting a positive year for the S&P 500 up greater than 5% on a price basis plus a dividend yield at the beginning of the year of close to 2%. Importantly the big call this year is for yet another year of positive returns for the equity markets by year end.

- **Commercial Real Estate** –It would be easy to look at the worst performing sectors one year and predict them to play catch up and be out performer the next year. If so Timber (up 6.3 % in 2014) or Free standing retail (up 8.39% in 2014) would be this years out performers. However, Timber needs new home starts and Free Standing Retail is dealing with shifting merchandising and buying patterns due to the internet. Areas of the economy we see driving the fundamentals of real estate going forward are downsizing of housing by baby boomers and businesses using less retail space and more storage space for inventory – so Self Storage we think performs well. We also see Health Care as a continuing demographic trend and that sector enters 2015 with one of the highest dividend yields as well.
- **Residential Real Estate** - should continue to see some moderate price improvement in the lower end of the market place. Downsizing by the baby boomers and first time home purchases by the millennials and echo boomers will both be looking for the same price points – the mid and low end of the market. There could also be some pent up home demand that should come to the market if mortgage rates are perceived as ready to start to drift higher. Affordability will become the key metric to lending and that becomes harder as rates rise. Prices are still below the peak prices in 2006-07, but this year could see prices continue their comeback with the S&P/Case Shiller price index up by close to 5% again in 2015.
- **Inflation** - will begin the year very much in check due to the significant decline in energy prices in the 4<sup>th</sup> quarter of 2014. Energy is not a component of CPI, but is included in Transportation and generally can have an impact on several other components as well. Our household inflation seems to go up more than the stated inflation rate as we feel the impact of Medical and Food and Beverage every day. But Apparel and Recreation are two components that keep the index down. And importantly the stronger dollar will make imports cheaper. All told we think that until interest rates start to inch higher, the pressure to raise prices will continue to be contained and while we see it higher than in 2014, **we do not believe it will be above 3% for the year.**

Now the fun begins – the out of the box thinking trying to identify something that no one is talking about now that might happen in the next year – or to touch the major topic of the day and get on record with perhaps a controversial opinion. We have gone overseas in past years for some of these with varying degrees of success. We even ventured into sports one year. The idea is to have some fun and show that there are things that can come out of left field that can influence our short-

term attention, but may in reality not impact our long-term investment principles. And other things that are not being talked about, but may have a profound impact on our lives in the future.

- **Oil Prices** – The massive decline in oil prices at the end of 2014 has many of our investors asking where does it go from here? While we may never know if there were behind closed door political reasons for any of the price movement; the impact on some of the oil dependent regimes around the globe that are aggressive or fund terrorism has been perhaps a side benefit to the decline in prices. We do know that history has shown us that basic economics play out in the oil industry. When there is more supply than demand, the price drops. In the past, that supply has been controlled at the margin by OPEC. But non-OPEC producers now control far more production, including the United States. And the United States production is controlled by “for-profit” corporations that will shut uneconomic wells and lower development budgets dramatically until profit can be realized again.?? Albeit it at a slower pace than a political decision by Saudi Arabia. Therefore, we think that the United States is in effect the producer on the margin who will bring supply and demand back in balance. While we feel that \$65 dollars is a fair price for oil to equalize at, it may go up slower than it came down and we see the second half of the year the potential for a spike to over \$70.
- Republican Senate passes tax bill to lower rate to repatriate overseas corporate cash. Done once before in the Regan administration we think it will happen again. It is politically attractive for both sides of the aisle and with Presidential politics fast approaching it may be the only sort of legislation that can get done.
- African Infrastructure investing expands – Behind the scenes there seem to be more articles being written on the investment potential of the African continent. Certainly the industrialized world needs to find areas of the world for their expertise to be utilized. No we will not get into the exploitation argument here, but rather the empirical observation that a significant growth in the amount of infrastructure investments will begin in 2015.

### ***Closing Comments & Thanks***

One of the things we work on constantly is trying to pay attention to what is happening from a slightly removed perspective. Getting wrapped up in the short term news cycle can cause a person to at times lose some perspective. Sometimes the macro trends are so obvious, but moving so slowly that we lose focus on them. The water Infrastructure in America is crumbling and needs replacement – do we wait for water mains breaking to cause problems to hit the news cycle, or do we realize there is investment potential in dealing with the issue. The Baby Boom generation is aging – does that mean there will be demand for medical services – most definitely. Are over 50,000 products made with a petroleum base and a core demand that has shown inelasticity with price to provide an ever increasing demand for petroleum? Yes. One more obvious item – the proliferation of debt worldwide. Below is a chart showing Total Public Debt as a percentage of GDP here in the U.S. We don’t believe there is anyone that would argue this is a potential bubble that needs to be dealt with. Fortunately, at present the actions of central bankers around the world to keep interest rates extremely low in attempt to stimulate growth, has the added benefit of slowing the compounding of this debt.

## TOTAL PUBLIC DEBT AS % OF GDP IN THE UNITED STATES



Another major obvious item that has come upon us investors through gradualism is lower interest rates on fixed income investments. Interest rates have slowly drifted lower over the past 35 years! Literally, for decades conventional wisdom has said that when you approach/attain retirement your investment should be weighted heavily to ownership of fixed income. We believe that perhaps the obvious – that interest rates will not support a retirement – needs to be looked at, and perhaps each investor needs to look at retirement finances and investing with a different paradigm going forward. We will be completing a paper on just this subject in the first month or two of the year and will share it with you as soon as it is published. In the meantime, we welcome a conversation with you about this topic and your individual situation.

As always we want to thank you for your continued confidence and the opportunity to manage your investments. We take very seriously our responsibility and will always endeavor to be responsive to your questions and concerns. We welcome and encourage your comments as well.

Montecito Investment Portfolio's Mission: To provide diversified, disciplined long-term investment solutions, service and guidance to help our clients achieve their "Financial Independence".

Sincerely,

Blake Todd, AIF®, CWS  
Portfolio Manager

Jarrett Perez, CFA  
Associate Portfolio Manager

## **DISCLOSURES**

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Real estate investments may be subject to a higher degree of market risk because of concentration in a specific industry, sector or geographical sector. Real estate investments may be subject to risks including but not limited to declines in the value of real estate, risks related to general and economic conditions, changes in the value of the underlying property owned by the trust and defaults by borrower.

The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ.

The Standard & Poor's 500 Index is a capitalization weighted index comprised of 500 widely-held stocks on US stock exchanges. Companies included in the index are selected by the S&P Index Committee, a team of analysts & economists at Standard & Poor's.

S&P 500 Total Return Index is a measure of the price movement of The Standard & Poor's 500 index and including the dividends paid by the companies in the index.

S&P Case Shiller Index – a group of indexes that tracks changes in home prices throughout the United States. Case-Shiller produces indexes representing certain metropolitan statistical areas as well as a national index.

GDP – the monetary value of all the finished goods & services produced within a country's borders in a specific time period.

The MSCI US REIT Total Return Index is an index that broadly represents the price and income movement of the equity REIT universe in the United States. The Index represents approximately 85% of the US REIT universe.

The Barclay's Aggregate Bond Index – includes government securities, mortgage-backed securities, asset-backed securities and corporate securities to simulate the universe of bonds in the market. The maturities of the bonds in the index are more than one year.

P/E Ratio is a valuation ratio of the company's current share price compared to its per-share earnings.