

SELECT 40 (40 S&P 500 stocks)

Investment Process, Margin of Safety and Investment Return vs. Speculative Return

Executive Summary:

The purpose of this white paper is to review Boston Harbor's systematic fundamental investment process based on our proprietary Microeconomic Theory of The Firm ("the Model") and to demonstrate how the Model attempts to protect against the consequences of being wrong. The Model's intellectual foundation is Margin of Safety; the principal concept of investment as articulated by Benjamin Graham, *The Intelligent Investor* (1949).

The intelligent investor must focus not just on getting the analysis right, but must also insure against loss if that analysis turns out to be wrong - even the best analyses will be wrong (not work as expected) some of the time. For example, many investors put essentially all of their money into technology stocks in the 1990s. Ignoring Benjamin Graham's call for a Margin of Safety, and certain that they knew the probabilities of being right, they did nothing to protect themselves against the consequences of being wrong and suffered a permanent loss of capital in the 2000 Tech Collapse.

We will demonstrate that for SELECT 40 (40 S&P 500 Stocks) the consequences of being wrong are that the investor can expect to achieve the long-term market rate of return. Given that the S&P 500 long-term outperforms about 86% of all large-cap funds¹, this would be a positive consequence for many investors.

When he was asked to sum up everything he had learned in his long career about how to get rich, the legendary financier J.K. Klingenstein of Wertheim & Co. answered simply: **"Don't lose"**.² Our mission is capital preservation, total return and liquidity. Our Model protects the investor against J.K. Klingenstein's permanent loss of capital and from the consequences of being wrong.

The principal concept of Benjamin Graham's investment philosophy - Margin of Safety³ - explains the intellectual foundation for the SELECT 40 investment process. Graham suggests that the Margin of Safety concept may be used to advantage as the touchstone to distinguish an investment strategy from a speculative one.

Margin of Safety in the popular version is defined as a single concept: buy stocks or bonds or other assets at a purchase price less than intrinsic value; typically a discount of 33% to 67%.

¹ S&P Dow Jones Indexes, SPIV Scorecard, Mid-Year 2015

² Benjamin Graham, *The Intelligent Investor*, Revised Edition, Harper, (2006), Preface and Appendix by Warren E. Buffett. Updated with new commentary by Jason Zweig, pg 526

³ Ibid: Graham, Chapter 20: "Margin of Safety" as the Central Concept of Investment

However, Margin of Safety is a concept that has several important dimensions: investment vs. speculation, price vs. intrinsic value, portfolio diversification of 20 or more stocks, high quality dividend paying stocks, insure against loss, manage risk, and recognize both the probability of being right and the consequences of being wrong. According to Graham, a true Margin of Safety is one that can be demonstrated by figures, by persuasive reasoning, and by reference to a body of actual experience.

Our Microeconomic Theory of The Firm incorporates all of the concept dimensions of Margin of Safety even though it does not directly challenge the individual stock's intrinsic value market price – a concept that Graham acknowledged was imprecise:

“We must recognize, however, that intrinsic value is an elusive concept. In general terms it is understood to be the value which is justified by the facts, e.g., the assets, earnings, dividends, definite prospects-as distinct, let us say, from market quotations established by artificial manipulation or distorted psychological excesses. But it is a great mistake to imagine that intrinsic value is as definite and as determinable as is the market price.”⁴

Importantly, Graham, like our Model, looks to the past and bottom-up fundamental analysis of financial statements to discover intrinsic value to get to the future. The focus of that historical analysis is to confirm investment earnings persistence. We will discuss investment return vs. speculative return in detail later in this White Paper. **The goal of our Model is to generate superior investment returns and avoid speculative returns.**

Indeed, along with Benjamin Graham, John Bogle and Warren Buffet we believe that investment earnings drive long term stock prices. John Bogle in his recent paper, *Occams Razor Redux*, demonstrates that since 1871 to 2014 speculative return only adds 0.4% to investment return of 8.6% for a total return of 9.0%⁵.

In the context of Graham, Bogle and Buffett teachings, SELECT 40 strategy is simple and easy to understand. First, Identify those companies that exceed the long term average S&P 500TR return (“cost of equity capital”) with a Margin of Safety, a rate of return on equity greater than the long-term cost of equity capital. Second, using our proprietary Microeconomic Theory of the Firm (circa 1969), we analyze the company's financial statements to confirm that there is a reasonable expectation that each portfolio candidate will sustain its earnings and return on equity over SELECT 40's investment horizon.

⁴ Benjamin Graham and David L. Dodd, *Security Analysis: Principles and Techniques*, (1934), pg 17

⁵ John C. Bogle and Michael W. Noland, Jr., “Occam's Razor Redux: Establishing Reasonable Expectations for Financial Market Returns,” *The Journal of Portfolio Management*, (Fall 2015), pg 120.

The result is that over all 10 year periods for the last 20 years SELECT 40 (gross) annually outperformed its S&P 500TR benchmark by an average of 5.1%. SELECT 40 average annualized gross return 13.3% vs. S&P 500TR average annualized return 8.2%.

We stated at the beginning that *“The intelligent investor must focus not just on getting the analysis right, but must also insure against loss if that analysis turns out to be wrong - even the best analyses will be wrong (not work as expected) some of the time.”*

Implicit in that statement is that the investor is making a “bet” that might not work out and the consequences of that bet not working out are a permanent loss of capital rather than a temporary impairment of capital.

The central question to be addressed is: “if SELECT 40 investment strategy does not work as expected is the consequence a permanent loss of capital?”

We expect, based on 25-years of historical portfolio statistics, SELECT 40 to outperform the S&P 500TR long-term by about 50% with about 30% less volatility risk. We expect SELECT 40 to have a long-term Up Capture of about 80% and a Down Capture of about 45% and to have a long-term Beta of about 0.62 Therefore, SELECT 40 is expected to deliver strong **absolute** returns in Bull markets and strong outperformance in Bear markets with temporary capital impairment about 50% lower than the market drawdown.

Since inception April 1, 1990 to January 29, 2016 SELECT 40 performs on a monthly basis as expected 59.4% of the time, better than expected 28.4% of the time and worse than expected 12.3% of the time. SELECT 40 annual performance has been as expected based on the portfolio statistics. For the 25 years ended December 31, 2015 SELECT 40 (gross) outperformed the S&P 500TR 52% of the time and for the 10 years ended December 31, 2015 60% of the time. For the 25 year period ended December 31, 2015 SELECT 40 (gross) annualized returns are 13.47% vs. S&P 500TR 9.51% and Alpha 7.65%.

We conclude that because SELECT 40 has an observed very large Margin of Safety available to absorb bad events before its performance declines to the level of the S&P 500, the consequence of SELECT 40 not performing as expected is low.

Boston Harbor Investment Process

Microeconomic Theory of the Firm, Margin of Safety and Consequences for SELECT 40 Not Performing as Expected

Model Goal:

SELECT 40's goal is to outperform the S&P 500TR benchmark long-term with high risk-adjusted returns while meeting our goals of capital preservation, total return and liquidity.

Model Foundation – the Universe:

Today, we only use our proprietary Microeconomic Theory of The Firm (circa 1969) to select stocks from the S&P 500 universe. The economic Model can be expanded to other universes to expand investment capacity from an estimated \$20 billion to \$60 billion.

Defining the stock selection universe as the S&P 500 immediately creates an advantage for SELECT 40. The S&P 500® Index is widely regarded as the best single gauge of large-cap U.S. equities. As of December 31, 2015 Standard and Poor's reports there are over \$7.8 trillion benchmarked to the index, with index assets comprising approximately \$2.2 trillion of this total. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

A company does not become an S&P 500 constituent with a minimum market cap of \$5.3 billion unless it has a competitive advantage, financial viability and trading liquidity. Those are the characteristics of the stocks we want in the Defensive Growth SELECT 40 portfolio.

Three Step Investment Process:

SELECT 40 is a systematic, simple, repeatable, and durable investment strategy, with a three step efficient process utilizing six variables. The investment process can be described as negative stock selection. Keep the losers out of the portfolio and the winners will take care of themselves. SELECT 40 is erected on the intellectual foundation of Benjamin Graham's concept of Margin of Safety. **It passes the ultimate test for any investment strategy - avoids the risk of catastrophic loss.** It does that automatically by combining sustainable earnings with lower Beta; without sacrificing strong absolute returns.

The goal of the SELECT 40 investment process is to identify companies from the S&P 500 stock selection universe with acceptable rates of return on equity that can maintain their performance. Companies that fail to meet the requirement of each step in the process are eliminated as candidates for the SELECT 40 portfolio.

1. Step 1 – Model ROE and Margin of Safety Requirement

The rate of Return on Equity of each company must exceed the cost of equity capital by a Margin of Safety. We eliminate from the S&P 500 stock selection universe all companies that do not have a Rate of Return on Equity (“ROE”) greater than 9.0%. The S&P 500 total return for the 144 years (1871 to 2014) is estimated to be 9.0%⁶.

We next increase the ROE above 9% for the remaining stock selection universe to a rate that will generate a certain minimum excess return greater than the required cost of equity capital and eliminate companies that fail to meet this additional new hurdle rate. We typically will have eliminated at this stage about 200 S&P 500 companies from the S&P 500 stock selection universe.

The remaining approximate 300 S&P 500 companies will have an average ROE greater than the S&P 500 universe.

We can reasonably expect those 300 higher ROE stocks or a random portfolio to do no worse than the S&P 500. A random selection of a 40 stock portfolio should have a probability of gain and consequence of loss that is at least equal to the market.

Importantly, because of the Model’s S&P 500 stock selection universe and ROE Margin of Safety, SELECT 40 does not carry any independent catastrophic risk of permanent capital loss. **If SELECT 40 does not work as expected, SELECT 40’s risk of capital loss is reasonably expected to be limited to temporary capital impairment caused by the equity market drawdown risk.** SELECT 40’s Margin of Safety is further increased by the below Steps 2 and 3 of the investment process.

2. Step 2 – Model Identifies Companies with Persistence

The Model eliminates from the remaining approximate pool of 300 stocks those companies that may not be able to maintain their ROE. We eliminate from the portfolio those companies that may not have sustainable and growing earnings over the SELECT 40 investment horizon of 18 to 24 months (persistence).

The Model identifies information in the financial statements (rather than challenge the market price) that may not yet be embedded in the market price. We carefully analyze financial statements and identify, among others, declines in quality factors and conflicts between the income statement and the balance sheet that could have a negative impact on ROE and Wall Street’s expectation of sustainable earnings in the next 18 to 24 months⁷.

⁶ IBID: Bogle and Nolan, pg 120

⁷ Sloan, Richard G. “Do Stock Prices Fully Reflect Information In Accruals And Cash Flows About Future Earnings,” *The Accounting Review*, Vol. 71, No.3 (July 1996), pp 289-315. Sloan shows that accrual earnings have a different

Our fundamental, bottom up, analysis of financial statements is different from traditional Wall Street analysis. Wall Street typically analyzes levels of the financial statement variables and forecasts the future. We believe that the market is reasonably efficient and therefore that information is already embedded in the market price. Consequently, we have no reason to believe that we can forecast the future better than the market and effectively challenge the market price.

We do not forecast the future, but we do rely on sustainable earnings (persistence) for our expectations of the future (large high return corporations typically change direction slowly). To get to the future the Model analyzes the rate of change of the Model's variables. We believe that rate of change information may not be fully embedded in the market price. If it was, SELECT 40 could not outperform a reasonably efficient market long-term. However, it does outperform for the 20-years ending December 31, 2015 by (gross) 5.1% annualized return. In addition, that outperformance includes a high (gross) 18.9% Modigliani M2 risk adjusted return.

We remove any company from the portfolio that does not pass ALL of the Model's pass/fail high probability of sustainable earnings criteria. If we do not select a company it does not mean that it is a short candidate or that that stock will not go up. It only means that it does not meet our Model's criteria.

At this stage we have decreased the stock selection universe from about 300 stocks to an average portfolio of 85 stocks.

3. Step 3 – Market Confirmation Of Model's Stock Selections

We believe that the market rewards safe, stable, and growing earnings with lower Beta (we recognize that many other factors can also cause a stock to have low Beta). For our average portfolio of 85 companies we leverage the market's knowledge to confirm our Model's stock decisions by ranking the 85 stocks by Beta and selecting the 40 lowest Beta stocks for the SELECT 40 portfolio. We are cognizant of Benjamin Graham's admonishment not to over diversify a portfolio. Our diversified forty stock portfolio does not attempt to diversify by industry or sector and consequently can be overweighted or underweighted as compared to these measures of diversification.

Conclusion to Investment Process:

We increase our Margin of Safety above a Margin of Safety created by a portfolio of higher than market ROE stocks, by using our Model to select a diversified portfolio of companies that have a high probability of sustainable earnings with lower Beta. We

persistence than cash earnings. Richardson, Sloan and Tuna (2002) extended that analysis to the various components of accruals.

further decrease risk by rebalancing that portfolio once a year to remove and replace companies that no longer meet our robust sustainable earnings and Beta-risk criteria.

SELECT 40's high probability of sustainable earnings portfolio has an average 20-year Beta of 0.57 and is highly resistant to maximum peak-to-trough drawdown. The portfolio has recovered from any major decline to a prior peak faster than the market over the last 25 years. For example, Financial and Tech Collapses , respectively, 18 and 19 months vs. 58 and 79 months for the S&P 500 .

Our Model has embedded in its rules the knowledge to systematically select portfolios of stocks that can be described by Holdings Based Style Analysis (“HBSA”) factors (but not selected by factors) as Large-Cap, Growth, Quality, Low Beta, High Corporate Governance, High Active Share. Returns Based Style Analysis (“RBSA”) reports SELECT 40 changes attributes from Growth to Value over market cycles.

Benjamin Graham summarizes that what SELECT 40 does is very hard to do and why SELECT 40 outperforms:

*To obtain better than average investment results over a long pull requires a policy of selection or operation possessing a twofold merit: (1) It must meet objective or rational tests of underlying soundness; and (2) it must be different from the policy followed by most investors or speculators. Benjamin Graham, *The Intelligent Investor*, 1949, Chapter 7.*

SELECT 40's systematic investment strategy qualifies for Ben Graham's “better than average investment results.” It is based on a rational Microeconomic Theory of The Firm and that Model selects stocks different from Wall Street. It is fundamentally a negative stock selection process – remove the high probability underperformers from the portfolio and keep the well-managed, healthy, sustainable earnings high probability outperformers.

A statistical review⁸ of SELECT 40 vs. S&P 500TR explains its April 1990 to December 2015 annualized return 3.96% outperformance by the four moments of the distribution. The four moments of the distribution are summarized by SELECT 40's Omega Ratio 2.44 vs. S&P 500 1.68. The SELECT 40 advantage 1.45x and about equal to SELECT 40's long-term outperformance of about 50% as compared to the benchmark.

In summary, SELECT 40 20-Years ended December 31, 2015 Annualized Return Gross 13.3% and Alpha 8.6% compared to the S&P 500TR Annualized Return 8.2%.

SELECT 40 and Sources of Stock Market Returns

Our Microeconomic Theory of The Firm is a systematic, fundamental, investment strategy based on the economic rationale that earnings (“investment return”) drive stock

⁸ Boston Harbor SELECT 40 Large-Cap Low Volatility Strategy: Statistical Review, January 2016

prices. We examine the two sources of stock market returns: investment return and speculative return to validate the critical premise of our Model.

Part 1:

Sources of Stock Market Returns:

John Maynard Keynes, *General Theory of Employment, Interest, and Money*, 1936, Chapter 12: “On the State of Long-Term Expectations.” Keynes enumerated two sources of stock market returns: enterprise and speculation, respectively, forecasting the actual business results of corporations and forecasting the psychology of the market. Keynes made no known attempt to quantify enterprise and speculation.

Early in the 1990’s John C. Bogle connected Occam’s concept of simplicity to the wisdom of John Maynard Keynes. In three articles published in 1990’s and updated in 2015 in *The Journal of Portfolio Management* he presented a new, simple methodology for establishing reasonable expectations for decade long returns on the two primary financial assets—stocks and bonds.

Bogle redefined Keynes’s enterprise to “investment return or fundamental return” and speculation to “speculative return”. Investment return is equal to the dividend yield at the start of the period plus the annual rate of earnings growth for the period. Speculative return is the annual percent rate of expansion or contraction of the price/earnings multiple during the period. This simple formula—the Bogle Sources of Return Model for Stocks (BSRM/S)—was designed to serve as a sound basis for developing reasonable expectations for future equity market returns:

$$R_t = D_0 + G_t + \Delta P/E_t$$

R_t is the expected return over some period of time t (ten years), D_0 is the dividend yield at the beginning of period t , G_t is the annual expected growth in nominal earnings per share during period t , and $\Delta P/E_t$ is the expected annualized rate of change in the price/earnings multiple over period t .⁹

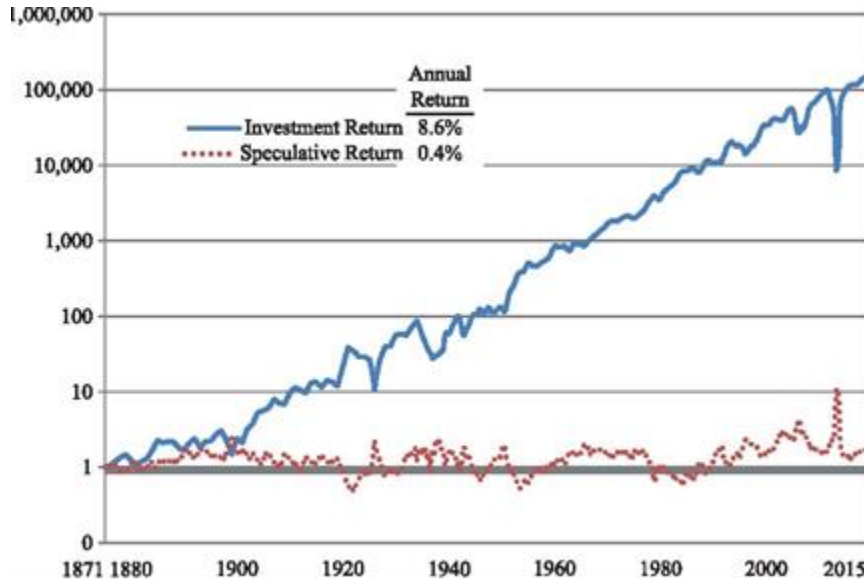
Bogle’s investment return represents the intrinsic value that corporate businesses create.

Bogle’s historic return data for the 144 years from 1871 to 2014 show a steady rise interrupted by episodic crashes from the trend line’s upward slope. Since 1871 investment return has grown at a nominal annual rate of 8.6%. Speculative return has no such stability, nor does it exhibit any long-term upward bias. The P/E ratio has had substantial fluctuations and speculative return only produces a 0.4% addition return.

⁹ Ibid: Bogle and Noland, pg 120.

Exhibit 1

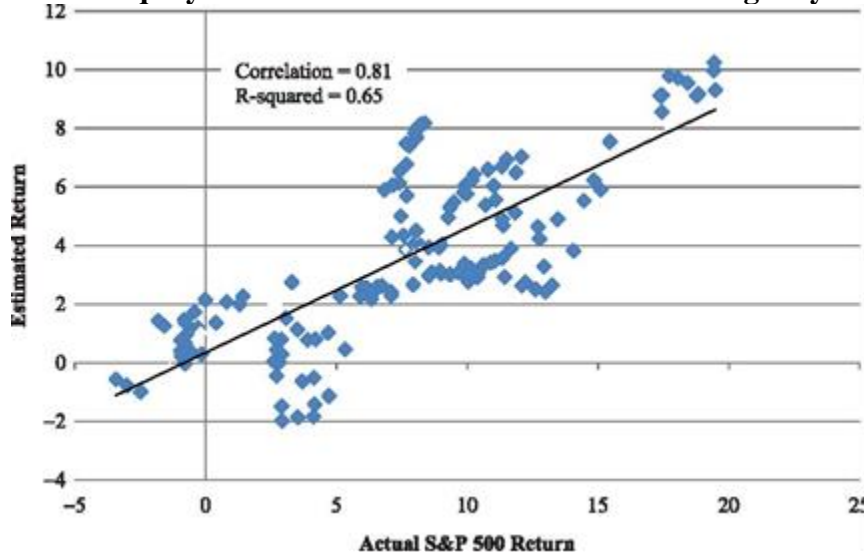
Cumulative Investment Return and Cumulative Speculative Return, 1871-2015 reports an Annual Return of 9.0%¹⁰



During 1990 to 2014 reasonable expectations for annual stock market returns from Bogle’s model were 9.2%. In fact the total return for the S&P 500 came to 9.6%-almost identical. Importantly, for this period Bogle uses an Annualized Return Rolling 10-Year Holding Period in order to build a “robust data set”, which is exactly Boston Harbor’s method to compute SELECT 40 returns and risk. While robust data sets and statistical analysis allows us to define risk with certainty based on actual observed data that analysis does not eliminate all risk. The risk of future uncertainty always remains.

Exhibit 2

Actual Equity Returns vs. Predicted Returns – Moving 10-year Periods, 1990-2014¹¹



¹⁰ Ibid: Bogle and Nolan, pg 120

¹¹ Ibid: Bogle and Nolan pg 120

Bogle's model establishes that the long-run average total return of 9% for stocks during the past century has been about investment return- intrinsic value and growth of earnings- and not about speculative return.

Warren Buffett's annual chairman's letters to Berkshire Hathaway shareholders tracks growth of earnings and book value to underscore the importance of that relationship to stock price. Warren Buffett's live track record is a clear demonstration that investment return drives stock prices. Berkshire Hathaway Inc.'s 2015 Annual Report exhibits the historical annual percentage gain record resulting in a compound annual gain 1965-2015 in Berkshire per Share Book Value of 19.2%. The corresponding Berkshire per Share Market Value was 20.8% vs. S&P 500TR Index of 9.7%. In the long-run Berkshire's compound returns of market value per share and increases in book value per share from retained earnings converge.

There is no doubt that earnings growth drives stock prices and is the source of stock market returns. Graham and Dodd, Keynes, Bogle, [R.J. Shiller, *Irrational Exuberance*, (2000), PE/10 Ratio] and Warren Buffett agree.

SELECT 40 is linked to earnings growth for driving stock prices and investment return rather than speculative return:

SELECT 40 (40 S&P 500 stocks) Microeconomic Theory of The Firm systematic investment strategy is anchored to a company's fundamentals and is used to identify from the financial statements a high probability of sustainable earnings growth. If, contrary to the historical record 9% return, due primarily from investment return earnings growth, the market decides that speculative return is the driver of long-term stock market returns; SELECT 40 will not work as well given its historic portfolio statistics, however, it is likely to produce strong absolute returns.

Speculative Return:

The evidence for the not working as well (not keeping up with the S&P 500TR) speculative return caveat is based on the S&P 500TR 1990s historically high 18.2% annualized return¹². This was when the P/E multiple at the end of 1999 reached a historic high of 31.6¹³. For the decade of the 1990s, the returns for BSRM/S (Bogle's 10 year rolling returns) and SELECT 40 are, respectively, 10.9% investment return and 15.4%. The 1990s underperformance of those fundamental based models is primarily attributed to S&P 500TR's speculative return multiple expansion of 6.9 %.

Part 2:

Sustainable Earnings, Growth Rate and Shareholders' Equity, Macroeconomic View:

The macroeconomic view of sustainable earnings is not the same as the more difficult decisions required to define whether a company's earnings are sustainable (persistence).

¹² Ibid: Bogle and Nolan pg 122

¹³ Ibid: Bogle and Nolan pg 122

The concept of sustainable growth was originally developed by Robert C. Higgins (1977). The Higgins sustainable growth rate of a company is the maximum rate of growth in sales that can be achieved given the firm's profitability and desired dividend payout and debt (financial leverage) ratios.

Our sustainable growth rate factor provides an insight into the future growth potential of earnings. The assumption is that the sustainable growth rate defines the reasonable expectations for future earnings growth, assuming the firm is able to continue to generate its existing rate of return on equity, and continues to reinvest its profits at the same rate. Several basic equations related to sustainable earnings are presented below:

$$\text{Sustainable Earnings Growth Rate} = [\text{ROE}] \times [1 - \text{Dividend Payout Ratio}]$$

$$\text{Sustainable Earnings} = [\text{Equity} \times \text{ROE}] \times [1 - \text{Dividend Payout Ratio}]$$

Total earnings (Equity x ROE) minus dividends equals the increase in equity. The ROE ("Net Income/Equity) is an accounting number measure of profitability. Importantly, Net Income and Equity are the only two summary accounts in financial statements and all the information about the firm's operating performance is embedded in the key ROE profitability ratio. The challenge is to extract that information to forecast changes in the ROE that will add value.

A company can grow its equity at a rate equal to its ROE if dividends are reinvested (not paid) or at the Sustainable Earnings Growth Rate if dividends are paid. If the ROE is maintained earnings will increase as the equity grows and increases in earnings drive stock prices. To quote Benjamin Graham:

"If the picture is viewed as a whole, there is a reasonably close connection between the growth of corporate surpluses through reinvested earnings and the growth of corporate values."¹⁴

The complex relationships between ROE, book value, required rate of return, earnings, dividends, growth, and stock value are precisely articulated in the Residual Earnings Stock Valuation Model.¹⁵

In summary, sustainable earnings growth rate and the growth in shareholder's equity long-term are reasonably expected to drive the stock price. Berkshire Hathaway's dividend payout ratio is zero because it does not pay any dividends. Warren Buffett's policy is to reinvest 100% of earnings and maximize the growth rate of shareholder equity. Berkshire Hathaway's stock price has benefited spectacularly from that decision. For the period 1965-2014, Berkshire Hathaway per share compound annual growth of book value 19.4%, stock price 21.6% vs. S&P 500TR Index 9.9%.

¹⁴ Ibid: Benjamin Graham, pg 514-515

¹⁵ Penman, Stephen, *Accounting For Value*, Columbia University Press, (2011).

We agree with Benjamin Graham – there is a reasonably close connection between the growth of book value and growth of the stock price. Our link to Benjamin Graham and the Bogle’s BSRM/S is that SELECT 40 selects stocks of well-managed, healthy, companies that have a high probability of sustainable earnings.

While Bogle’s model forecasts S&P 500TR returns for a decade ahead, SELECT 40 selects portfolios that rebalance annually and outperform the S&P 500 by about 50% with about 30% lower volatility-risk. SELECT 40 achieves those returns by following Benjamin Graham’s sage advice to make investments rather than speculate and to maintain a Margin of Safety.

Conclusion

We have demonstrated that our Microeconomic Theory of The Firm (the Model) is a systematic investment strategy supported by the economic rationale that sustainable earnings drive stock prices. SELECT 40 does not carry any independent catastrophic risk of permanent capital loss beyond the equity market risk if it does not work as expected, because its foundation is anchored to Margin of Safety. Benjamin Graham’s Margin of Safety is a concept that has several important dimensions: investment vs. speculation, price vs. intrinsic value, portfolio diversification of 20 or more stocks, high quality dividend paying stocks, insure against loss, manage risk, and recognize both the probability of being right and the consequences of being wrong. According to Graham, a true Margin of Safety is one that can be demonstrated by figures, by persuasive reasoning, and by reference to a body of actual experience. Our Model incorporates all of Graham’s Margin of Safety specifications and its portfolios outperform with a very comfortable Margin of Safety.

Dennis N. Caulfield
Chief Investment Officer

March 2016

DISCLAIMER FOR HYPOTHETICAL RETURNS

Only SELECT 40 hypothetical returns for 25.75 years ended December 31, 2015 are reported to avoid mixing hypothetical and composite live returns. Since April 1, 2013 SELECT 40 composite live returns are available upon request and have a tracking error to hypothetical returns of 0.30%. Hypothetical returns from March 31, 2008 to March 31, 2013 are not back-tested, but are not live portfolios.

All hypothetical returns are gross of advisory fees and transaction costs; all dividends are assumed to be reinvested annually. Actual Strategy returns from live portfolios may differ materially from hypothetical returns. There is no substitute for actual returns from a live portfolio.

Back-testing is done by retroactively applying a hypothesis to the historical data to obtain returns (scientific method) or finding variables in historical data that correlate to returns and developing a hypothesis from the historical data (data mining) or applying any hypothesis to different time periods until favorable returns are discovered (data mining).

Back-tested models are developed with the benefit of hindsight but might not have foresight of the future. Hypothetical returns do not reflect the macroeconomic risks of using the Strategy in a different time period or the financial risk of executing trades in a live portfolio which include the potential market impact on stock prices caused by buying or selling that could cause the model's buy or sell prices to differ from the frictionless trades of the back-tested model.

Although the information presented gives you some idea of the risks involved in investing in the Strategy, **PAST HYPOTHETICAL PERFORMANCE IS NOT A GUARANTEE OR A RELIABLE INDICATOR OF FUTURE RESULTS.** All investments contain risks and may lose value.