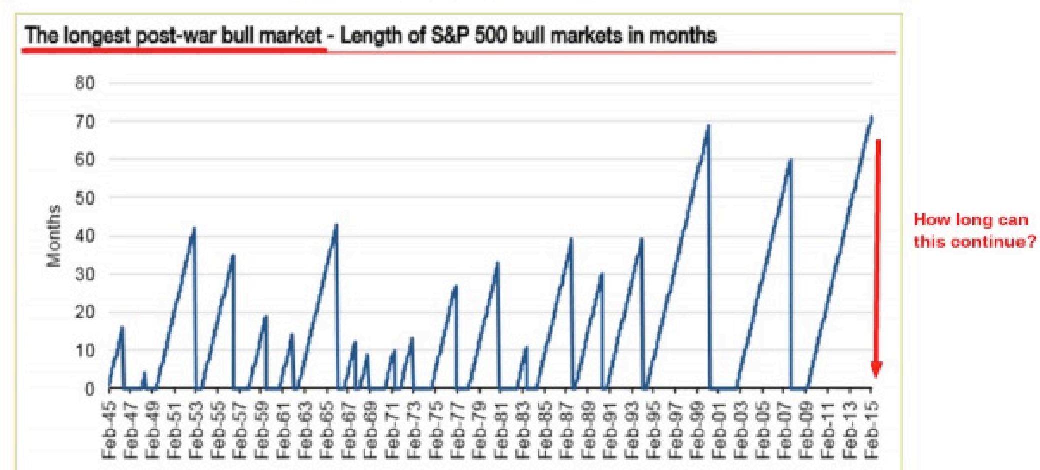
"Never forget that 2+2 will always equal 4. And when someone tells you how old-fashioned that math is --- zip up your wallet, take a vacation and come back in a few years to buy stocks at cheap prices." – Warren Buffett

Avoiding Avalanches

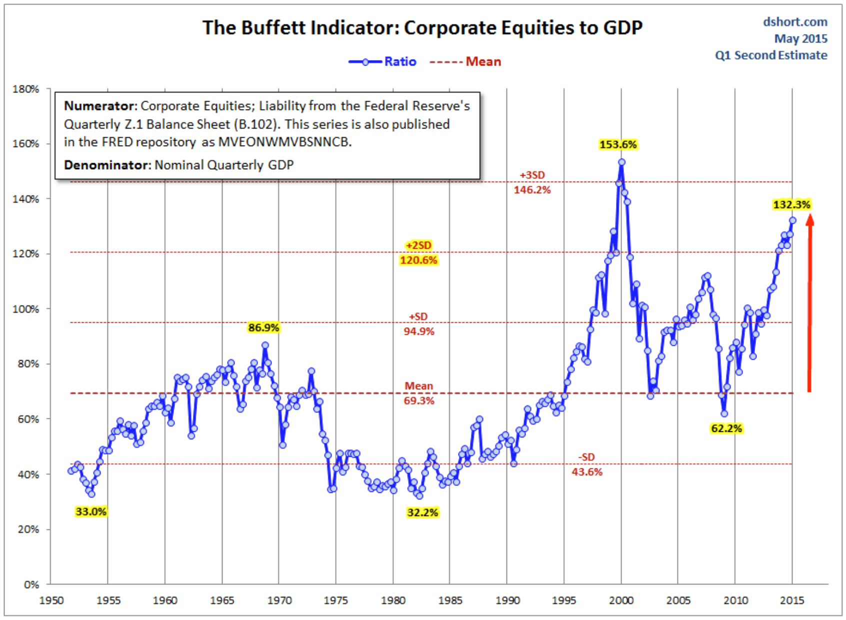
- Very little has changed since our last letter. Markets remain dangerously high, though the cracks may be starting to show. Greek default? Chinese meltdown? Event X, Y, Z? We don't know what will spark the panic, just that there's a lot of dry tinder built up since the last burn.
- It's been an exceptionally long time since the last real panic. The chart below shows how this is currently the longest uninterrupted bull market run since WWII. Even a simple measurement like months up without a pullback should cause some uneasiness.

Length of S&P 500 Bull Markets



Source: http://1.bp.blogspot.com/-xBLEfg8gZBo/VQKJkLfy_rI/AAAAAAAAc8E/Ozyzgbn3Lql/s1600/SG%2B2015-03-13B.png.

- A correction has actually already started: this year, 1 in 5 companies in the S&P 500 are down 20% off their highs (compared to just 1 in 20 companies down that amount in 2014).
- Complex adaptive systems like the stock market tend to be non-linear and follow power law distributions. That's what makes the timing nearly impossible. Events slowly build, until major changes precipitate all at once. Think of an avalanche. Each added snow flake increases the chance of the whole mountainside giving out, but you never know which one will be the final straw (just that you shouldn't be standing under it!).
- Mr. Buffett's favorite measure of market-wide prices, Market Cap/GDP, remains elevated at 132% (compared to a long run average of 69%). It's no surprise that Berkshire has been quietly passing on any large transactions and building their cash levels to an all-time high of $70 billion in anticipation of better opportunities.



Headwinds and Pendulums

- The Russell 2000 is an index based on a collection of smaller sized companies. The chart below demonstrates how the market has recently preferred “growth” over “value” in the small cap space. To simplify, people have recently preferred exciting stories over boring business fundamentals.
- The yellow line is the relative performance of the “growth” subset of the index compared to the average (the white line). The green line represents the relative performance of the “value” subset of the index. As you can see, the green “value” portion of the market (where we typically search for deals) has dramatically underperformed since 2010. This chart implies there has been a statistical headwind for our style of investing for the last several years.

- This happens from time to time, usually toward the end of big bull runs like in the late 1990s. While this headwind is lamentable for value-oriented investors like us, we won't be changing our style to chase what's currently popular.
- The long-term trend seriously favors a value mindset (by 4.8% per year on average), as the chart below emphatically demonstrates. Any data point where the blue line is above zero (the vast majority), value has performed better than growth.
- One **recent study** found that after periods of prolonged underperformance, value bounced back by an average of 64% cumulatively over the following 6 years. We have every confidence the pendulum will swing back and we'll be swimming with the tide again. We just don't know "when" yet.

Exhibit 1: The History of Value Outperformance vs. Growth – 10-Year Trailing Periods from July 1, 1926 to June 30, 2014

Sources: Fama/French, Gerstein Fisher Research

- We have initiated small positions in a handful of companies that we think are undervalued and in the midst of successful turnarounds. On average, we think this collection of special situations will do well over the long term. Nonetheless, we are still extremely conservative and holding large amounts of cash for future opportunities.
- Reminder: Save the date of October 3rd for the annual FSI Bash.

As always, we're thankful to have such great partners in this wealth creation journey.

Jake & Lonnie

Performance since Jan 2008*	
FSI (after all fees)	+73.7%
S&P 500 (w/ dividends)	+65.5%

* Based on auditable track record of our flagship fund The 5505 Fund formerly named RCM Partners Fund.

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