CAZ Investments

Quarterly Letter

“What a Wonderful Year!”

If someone had asked us on January 1 what it would take for the markets to create a headline like that for 2013, we would have produced an answer that would have included:

- A definitive resolution to the ongoing budget debate and debt ceiling crisis in Washington
- Significant cash flow growth, in excess of 15%, from corporate America
- Meaningful job growth with a resumption of healthy hiring practices from companies
- Growth in the U.S. economy at a normal rate that exceeded 4%

Not one of those criteria was achieved. One thing that became clear in this environment was that blind faith was much more profitable than rational thought. With the benefit of hindsight, it would have been better to take more aggressive allocations into 2013. Ultimately, we will always focus on where the risks in the markets are, and we will position our portfolios to benefit from the best case with protections against the worst case. This past year turned out to be incredibly profitable for our portfolios for which we are thankful, but we are also realistic enough to know how the year could have seen a completely opposite result if a few things had not worked out the way they did.

When we look back on the year, we can summarize the reasons for the magnificent market performance as follows:

- The Federal Reserve kept the monetary spigot wide open with QE3, and the markets were happy to believe that there was a “floor” to the markets from the Fed’s apparent desire to talk up asset prices of all kinds.
- Companies did a good job delivering results from flat to slightly rising revenue streams, which was a result of all the cost cutting they did in the past few years. Even though revenue growth remained tepid, companies were able to grow earnings at the fastest rate we have seen since the great recession.
- The U.S. government succeeded in doing just enough to kick the can down the road and avoid total disaster, in spite of themselves, while not really accomplishing anything substantive at all.
- The European governments succeeded in doing just enough to kick the can down the road and avoid total disaster, in spite of themselves, while not really accomplishing anything substantive. (Notice a theme here…)
- International issues, when they did flare up, were relatively self-contained and did not pose any immediate threat to the U.S. economy or worldwide demand.

Due to these factors the markets around the world decided that "there was no place for cash other than stocks" and lifted the valuations for stock prices quite dramatically. Never forget that if a company's cash flow grows by 10%, and its stock price increases by 20%, the difference between the two is simply valuation. Higher valuations are based on expectations for faster growth in the future, and only time will tell if those expectations for faster growth will be met. As valuations grow, so do the downside risks if that growth does not materialize.

Now What?

That brings us to the most difficult question of all which is, "Now what?" As we start 2014, we can point out some absolutes:

- Valuations are more expensive now than they have been in many years. (See our 3rd quarter letter for the illustration of how the market has only been at this valuation level three times in modern history: 1999, 2006 and now.)
- The Government appears to have resolved some of the deadlock and has at least developed a path toward the avoidance of government shutdowns, etc.
- The Federal Reserve announced a small reduction in their bond buying program (QE3) of $10B a month. So they are now *only* purchasing $75B of our own government's bonds every month, or $900 Billion a year. (Just typing that figure is hard when considering that is our government lending money to our own government…)
- Interest rates have risen sharply from their absolute lows but are still a fraction of historical normal levels.
- The consumer has recovered and is beginning to resume more normal spending habits.
- Companies continue to be very cautious about hiring practices. They are hiring selectively, and have expressed a desire to hire more aggressively if they anticipate faster growth in the future.
- The jobless rate continues to drop via a combination of workers truly finding employment, and a startling number of people that are leaving the job market entirely.
- The problems in the U.S. and Europe have not gone away. They have just been swept under the rug for future politicians to handle.

When we process all of these data points we also add a couple of unknowns to the equation as we assess the probabilities around economic growth and market expectations.

- The health care reform process has been an unmitigated disaster up to this point, and it is likely to have a massively dilutive impact on the economy both from a direct cost of services and indirect costs of compliance and uncertainty.
- Emerging markets around the world are less stable than they have been in recent years, and there seems to be something brewing which could filter over into the developed markets.
- China is clearly slowing down, and the impact that will have on worldwide demand for goods is impossible to determine.

- The 2014 mid-term elections will create significantly more partisan talk which will dominate the news flow between now and November, along with the potential for posturing in Washington as a result of the desire to have something to "use" on the campaign trail.

So that leaves us in an uncomfortable place where we see a lot of positives and plenty of negatives. Ultimately, our job is to manage risk, participate in returns and strike a prudent balance for our clients' portfolios. For this reason, as we see significantly more downside potential in the markets than we see upside, we remain a **"2"** on the CAZ Scale (1 = most bearish, 5 = most bullish). We are much closer to moving down the Scale as opposed to up. We see more potential downside in the markets from these levels than we have since the beginning of 2007. That is not designed to scare anyone. We will remain invested in a prudent fashion, with appropriate allocations, but we will be biased toward caution. This should allow us to capture plenty of upside if the markets continue to thrive and move higher, but it is extremely important for clients to assess their risk and reduce exposure to stocks if they have not already done so.

The "No Brainers"

When we look at the world of investing we are always on the lookout for "no brainers." Those are the themes where it is almost impossible to see how something will *not* occur. These situations do not present themselves very often in life, but they do happen. Most of the time they are only obvious to people when they look back and ask themselves why they didn't see what was clearly so logical. Examples of "no brainers" in the past would be that tech stocks were grossly overvalued in 1999, housing prices were obscenely priced in 2006, the market was immensely undervalued in the spring of 2009, etc. The skill in our industry comes from being able to see these "no brainers" in spite of the world telling us that we are in a "new paradigm". Stated another way, significant value is added when one can "see the forest and not just the trees."

As we look at the landscape of 2014, we believe that there are a few "no brainers." First, we believe that it is unfathomable that long term U.S. interest rates are going to stay at these artificially low levels. Whether rates rise because the Federal Reserve stops buying $75B a month and supply/demand is allowed to take over, or the economy accelerates and becomes stronger does not matter. Ultimately, we believe rates will go up, and potentially go up a LOT. Next, we expect that the development of natural resources in the U.S., particularly Oil and Gas, will continue to increase for the foreseeable future. This multi-year trend is going to have a massive impact on our economy. Next, we believe that some of the assets that have been completely dislocated as a result of fears related to the reduction/elimination of QE3 provide significant opportunity.

Risk/reward scenarios of this magnitude are rare to find and present unique opportunities to generate profits. Finally, we believe that the population in this country will continue to become more and more Hispanic as this is the fastest growing segment of the population, and the math will only accelerate over the next few years.

When we find these types of major themes, we seek to find ways to profit from them. Ultimately, we will not invest in an idea unless we can find a suitable vehicle that provides us the combination of risk/reward that we demand. As a group, our principals and shareholders are by far the largest investors in our vehicles with more than $100mm of commitments. So, when we decide to invest in a theme, we are investing our own personal money and then inviting our clients to co-invest with us. Therefore, we move cautiously until we find that combination of risk/reward that we demand.

At this point we have identified specific ways to invest in two of the four themes: rising interest rates and increased oil and gas development. We are actively pursuing opportunities in dislocated assets, and the growth of the Hispanic population. Stay tuned for more information as we identify ways in which we are going to invest our personal capital in these areas. For now all clients should focus on the two themes that are actively being pursued.

Many of our clients are aware of what we are doing in the Mid-Stream energy space. That particular opportunity will only exist for the next sixty days or so, so time is of the essence. If you have not taken the time to learn what we are doing with our Interest Rate Opportunity Fund ("IRO"), please talk to us about this vehicle. As one of the most unique vehicles we have ever created, it provides that unusual risk/reward scenario where we can attempt to clearly quantify both our downside risk and upside opportunity. In this case we have what we believe is one of the most uncommon ratios of 10-15 times the amount of upside compared to the downside. Ratios of that type can rarely be created, and we encourage you to learn more about this opportunity if you have not already. Further, if you have a bond portfolio of any kind, it is imperative that you learn how many of our clients are using this vehicle to hedge their interest rate exposure.

New Initiatives

All clients received an email that explained our new communication initiatives for 2014. Those steps are underway, and we are in phase one of implementation. We will over communicate with you during this time in order to make sure you are fully aware of the progress that is being made and what actions, if any, that you need to take.

As discussed in the email a few weeks back, all managed account statements will now be delivered in one format, and all pooled vehicle statements will be delivered in a different format. You will love both, and we are excited to share these with you over the next few months.

All clients should have been notified of their new online portal, ShareFile, and hopefully you have already logged in. Our experienced client services team has created a very useful online tutorial and video to walk you through the steps necessary to access your information. We will also host a series of educational events in the next month or so, where we will gladly walk our clients through all of the technological resources and statements. We will send you the specifics for those events when they are finalized. In the meantime, do not hesitate to let our client services team know if you have any questions.

We are thrilled to be able to co-invest with you as we enter 2014. Please know how much we appreciate the confidence you have shown by partnering with us. Have a great start to the new year, and we look forward to seeing you very soon.