STEPPING STONES MANAGEMENT, LLC

First Quarter 2014 Commentary

April 17, 2014

Voltaire wrote to Catherine the Great in 1765, "I am older, Madame, than the city where you reign, I even dare to add that I am older than your empire." He was referring to St. Petersburg named for the man who not only created the Russian empire but in many respects, the modern concept of government. Before Peter the Great, most of civilization was administered by religious authorities, but not being the church going type, Peter resented that. He established official agencies to administer society's needs as he built the Russian empire and the industrial base that would sustain it after his death. He is called Great because he took a backward country and reorganized its military, acquired ports and built canals and other types of trade routes, making it great. Voltaire was amazed at how the czar transformed a nation "stagnating in ignorance, in the absence of all the arts" into a more civilized one based on what Peter learned in his youth traveling through Europe. Voltaire became Peter's biographer after writing about Swedish King Charles XII who also built an empire through military adventurism. He told that history so that kings would be "cured of the folly of conquests." He was obviously unsuccessful as Peter expanded his empire at Charles' expense over today's Ukraine and north to where he built St. Petersburg on the Baltic Sea as a "window on the West". Peter the Great and Russia have been enigmas ever since and the first quarter of 2014 saw the Russian empire back in the forefront of the world's consciousness.

21st Century Bear

It began in early February with Russia hosting the XXII Olympic Winter Games which saw her athletes take home more medals than any other nation. As the games were proceeding, Russian Special Forces were preparing to seize the Crimean peninsula which was achieved in the month of March without any shots being fired. Western leaders protested as Russian President Vladimir Putin denied that the soldiers wearing no insignia on their uniforms were even Russian. President Obama decried the 18th century behavior in our 21st century world and promised there would be costs to Russia if her troops did not withdraw. For a few weeks it looked as though those costs could be substantial as the Russian stock market fell by more than 10% while developed markets also sold off fearing sanctions that could disrupt western business interests in Russia. That however was seen as a cost too great to European countries already struggling under their own problems, so the sanctions were limited to a small group of individuals and one

Russian bank. Markets rallied in response with the S&P 500 reaching a new high to end the quarter with a gain of 1.3% while Russia's market regained most of its post Crimea decline.

Celebrating the addition of Crimea to the Russian Federation, Putin spoke of Russia being plundered by the international community after the dissolution of the Soviet Union, which he has separately called the greatest geopolitical catastrophe of the 20th century. He complained that "the infamous policy of containment, led in the 18th, 19th and 20th centuries, continues today" and told how Crimea has been part of Russia for most of the time since Catherine the Great acquired the land in the late 18th century. Putin called Kiev "the mother of Russian cities" and warned of similar oppression of Russians "underway in Kiev, Donetsk, Kharkov and other Ukrainian cities." Since then, tens of thousands of Russian troops have amassed on the border while demonstrations are heating up in the cities of Ukraine's eastern industrial heartland. If Putin were to "rescue" those Russians like he did in Crimea we would have to expect sanctions that would also bite into western economies.

Western Europe could feel the most pain as those countries are reliant on Russian natural gas that flows through pipelines transiting Ukraine. Despite Europe's ample natural gas fracking opportunities, stringent environmental policies relegate the continent to rely on Vladimir Putin for its energy which has made Putin's empire reliant on high energy prices. Nobody expects the west to go to war over Ukraine but the US could weaken Putin by auctioning federal leases to drill for oil and gas which could drive down international energy prices. Lower energy prices would add money to American wallets while the auctions would bring desperately needed revenue into the US Treasury.

Tapering Momentum

The need for revenue has become more acute now that the Federal Reserve has finally begun to taper their monthly Quantitative Easing (QE) bond purchases, gradually eliminating the largest buyer of US Treasury debt. As happened when earlier rounds of QE wound down, the strong equity bull market has begun to stumble. It coincided with the taper in the first few days of the year with a surprising and unusual selloff. If the "January Barometer" is accurate, the month's -3.5% decline signals negative returns for 2014. The 4th quarter earnings reports mostly exceeded expectations for a year over year gain of 8.5% in S&P 500 earnings but guidance for the first quarter was weak and that was before the polar vortex plunged most of the US economy into a deep freeze.

Economies around the world dealt with other problems such as violent asset flows in the emerging markets that witnessed double digit stock market declines to begin the year. Russia's largest US based ETF declined more in the month of January than it did in the selloff following the Crimea invasion and it gained back most of that latter drop by the end of the quarter. Emerging markets generally finished the quarter in rally mode and have continued to outperform in April as money has rotated out of the highly valued US stock market.

The second quarter has begun like the first with extended technology and biotech stocks suffering the way emerging markets did last quarter. CNBC's Jim Cramer says it is the most ferocious selling he has seen in the NASDAQ since the epic 2000 market top. He attributes some of that selling to the surge of recent initial public offerings (IPOs) of stock. Buyers of these IPOs have to take the money out of something else and those momentum stocks of recent years have been the preferred source of funds. He also points to elevated levels of insider selling, another sign of a market top.

The first quarter saw the most IPOs since the 2000 dot.com peak and like that prior occasion, more than three quarters of the offerings were for companies yet to earn a profit. If you built a company to the point where the public would invest, would you sell out before earning any profits? You probably would if your investment bankers told you it might be the best opportunity for a decade or more.

Arbitraging the Speed of Light

Not all the issuers on the IPO calendar are without profits though. In early March, Virtu Financial Inc. filed to raise $100 million which seems low considering the company paid out more than $430 million to its investors last year. The trading and market making firm has been in business since the beginning of 2009 and in the intervening 1,238 trading days (through December 31, 2013), they were profitable for all but 1, a 99.92% success rate. Virtu said it expected the high frequency trading (HFT) market they participate in to continue to grow but that was before the publication of Michael Lewis' new book *Flash Boys.*

Lewis has proven adept at finding compelling stories to highlight previously opaque areas of our financial markets. His latest offering has struck a nerve on Wall Street since he declared the US stock market to be "rigged". If that means to give one side of a transaction an advantage then he is right, but it has always been the case. With HFT, super fast computers get privileged looks at quotes and employ cutting edge fiber optic technologies to bid up prices in front of other orders. Skimming a penny here and there millions of times a day adds up to the type of profits that Virtu has produced. Defenders say that is the price of having liquid markets but a passage in the book from an institutional investor states it well. He says he used to worry a little about a guy named Vinny on the floor of the stock exchange who at the end of the day would get into his Cadillac and drive to his big house on Long Island. Now he worries a lot about a guy named Vladimir who gets into his jet and flies to his estate in Aspen for the weekend. The HFT programmers tend to be Russians raised in an era of scarce computer time, making them uniquely skilled at writing super fast programs.

Investors have voiced outrage that the financial industry would allow some clients to scalp others and Charles Schwab has declared the practice to be a growing and deep cancer undermining investor confidence in the fairness of the markets. In a form of 21st century crony capitalism, thousands of different order types have been approved by eager young SEC regulators who progress through Washington's revolving door to work for the HFT firms that propose the rules to suit their strategies. As troubling as it is, perhaps more scandalous is the evidence in the book that Wall Street "dark pools" – private exchanges that firms set up to protect their institutional clients from HFT scalpers – offer no protection and are even feeding the practice. It wouldn't be the first time Wall Street took advantage of its best clients and it likely won't be the last.

S&P 500 Per Share Fundamentals

	YEAREND 2008	YEAREND 2013	CAGR
SALES	$991	$1,104	**2.18%**
EARNINGS	$58	$108	**13.22%**
EQUITY	$511	$748	**7.93%**
INDEX PRICE	903.25	1848.36	**15.40%**
Yr End P/S	*0.91*	*1.67*	
Yr End P/E	*15.49*	*17.04*	
Yr End P/BV	*1.77*	*2.47*	

But all is well as long as prices keep rising. The key to that in the 21st century has been for the Federal Reserve to provide ample funds for Washington and Wall Street to pursue happiness. These letters (posted on our website) have warned about the consequences of the Fed's financial repression and now that the historic QE policy is ending, the true test is upon us. Looking at the last 5 years of fundamental data for the S&P 500 reveals an interesting story. The table shows that both the earnings per share of the index and the price have risen at mid teens compound annual growth rates, suggesting a rally built on solid fundamentals. Both metrics have doubled since the trough in 2009. The equity per share has grown only about half as much and the sales per share tell a different story rising at an anemic rate of just 2.18% per year, barely above the rate of inflation (which is understated by the Fed's repression of mortgage rates). The earnings have been able to grow through financial engineering aided by five years of QE. As that tailwind reverses, earnings will have to rely again on growing sales which have historically been the driver of earnings growth.

Valuations have improved somewhat with 2014's flat performance thus far but our view is that Fed policy combined with fragmented markets whipped around at the speed of light have increased instability not decreased it. We still maintain larger than normal cash positions awaiting recognition of those risks to provide an opportunity to reallocate at better valuations. In our fully invested equity ETF strategy, we reduced risk in the quarter by trading out of the South Korea and S&P 500 funds (EWY and SPY) and into the gold miners and utilities sectors (GDX and XLU). That portfolio managed a slight gain of less than 1% in the first quarter compared to the S&P 500's 1.3% rise.

Chairman Yellen has given no hints of backing off the tapering process and we expect some level of disruption as the monetary needle is withdrawn from the market's artery. It may be that the 21st century has ushered in a new age of enlightenment where the business cycle really can be tamed by printing money. Conversely, QE could provide a false sense of calm as traditional financial warning mechanisms are blunted by the Fed controlling the price relative to which all financial assets are priced. Most of those financial assets are now priced by HFT which accounts for more than half of stock market trading. Regulators and prosecutors have announced inquiries following the publication of *Flash Boys* and Goldman Sachs even closed down their proprietary dark pool. So much trading volume coming under such scrutiny increases the risks of a disruption as more of it will inevitably dry up, even if that is a good thing for the long term.

Shares of stock may now trade at the speed of light but the judo master Vladimir Putin has shown us that geopolitics have not changed much over the centuries, as he attempts to reconstruct Peter's Russian Empire. If Russia can lay claim to Crimea, Putin has an even stronger claim to the rest of Ukraine and Baltic NATO members could be next. 21st century leaders have unfortunately not been cured of the folly of conquests but weaponry has changed with Putin using his energy reserves more than guns and bombs. The US also has such weapons and even more powerful financial ones. Using any of them inevitably entails collateral damage but certain circumstances make that preferable to leaving them holstered. Recent news suggests Putin has not been dissuaded from continuing his expansion which would likely be a bridge too far for the Western democracies to accept without issuing stronger sanctions. It could be a good time to stock up on vodka and caviar.

We welcome the cooling off of 2013's torrid stock market gains and will look at any correction of the market's overbought and overvalued status opportunistically. As geopolitical realism makes a comeback, a similar bout of realism is striking our 21st century monetary policy. When that gets back to normal we expect the economy to slowly follow although the heavy yoke of the expanding regulatory burden on the economy remains. A positive glimmer can be seen in the first quarter's increasing level of commercial and industrial loans. Perhaps banks are replacing their loans to the US Treasury with loans to actual American businesses, a nascent trend we are hoping will continue.

Please feel free to call us to discuss any of your financial concerns. Until then and as always, thank you for your trust and thank you for your business.

Yours truly,

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