Q2 2013 Letter

Shih Investments

http://shihinvestments.com kai@shihinvestments.com

[For: Investment Partners]

Q2 2013 Summary

- [Balance and return information]
- We avoided several assets that fell this year, like gold, bonds and emerging market securities.
- Federal Reserve and interest rate uncertainty is creating volatile markets.
- We raised cash levels to 20% to take advantage of bargains that may arise.

Shih Investments

Account Statement 6/30/2013

YOUR ACCOUNT BALANCE: **$X,XXX,XXX**

PORTFOLIO SUMMARY

	Since: 1/1/2013
Beginning Balance	$X,XXX,XXX
+ Deposits	
− Fees	
+/− Market Value	$XXX,XXX
End Balance	**$X,XXX,XXX**

RETURN SUMMARY

	Since: 1/1/2013	Since: 1/1/2012	Since: 1/1/2011
Returns (before fees)	XX%	XX%	XX%
Returns (after fees)	XX%	XX%	XX%
S&P 500 index	12.6%	27.7%	27.7%
Barclay Hedge fund index	5.8%	14.5%	9.2%

FEE SUMMARY

Fellow Investors,

Our account balances reached new highs this quarter, capping off a year and a half of good returns. Our healthy returns are mostly the result of purchases from 2011 when I wrote that certain stocks "seem exceptionally cheap right now."

While we've experienced gains, many investments struggled this year. Many bonds have fallen this year. Emerging markets and gold prices have fallen sharply. Global equity markets lost a trillion dollars in a single day.

Investors have been jittery ever since the Federal Reserve (Fed) indicated that Quantitative Easing (QE) might end next year. Warren Buffett likened the ending of QE to a "good movie" stating he "did not know how it would end." I've included my thoughts on QE on the next pages.

I think the Fed's actions are uncertain (even to the Fed itself). I don't believe we will fully understand how the Fed's actions will impact the economy and financial markets for some time. Rather, I believe markets will be turbulent as investors react rapidly to the Fed. I have raised cash levels to 20%. Turbulent markets often create bargains, and I'll be eager and waiting to snatch them up.

Sincerely,

June 2013

I've included some thoughts on QE below. To summarize, there are a wide variety of opinions about the aftermath of QE. I don't have a strong opinion, except that markets will be volatile and may react strongly to each new piece of data. Therefore, I'm keeping an open mind and trying to find values as they come along. Here are some questions you may have:

- What is QE?
- What are QE's impacts on stock prices?
- When will QE end?

What is QE?

QE is the Fed's bond-buying program. The Fed is currently buying $85 Billion in government bonds and mortgage bonds each month in an attempt to lower long-term interest rates for the entire economy.

QE is considered an "unconventional" policy – historically, it's rarely been used. The impacts of economic policies are difficult to measure. Here, without even historical precedents, I think the impact of QE on the economy and markets are very uncertain.

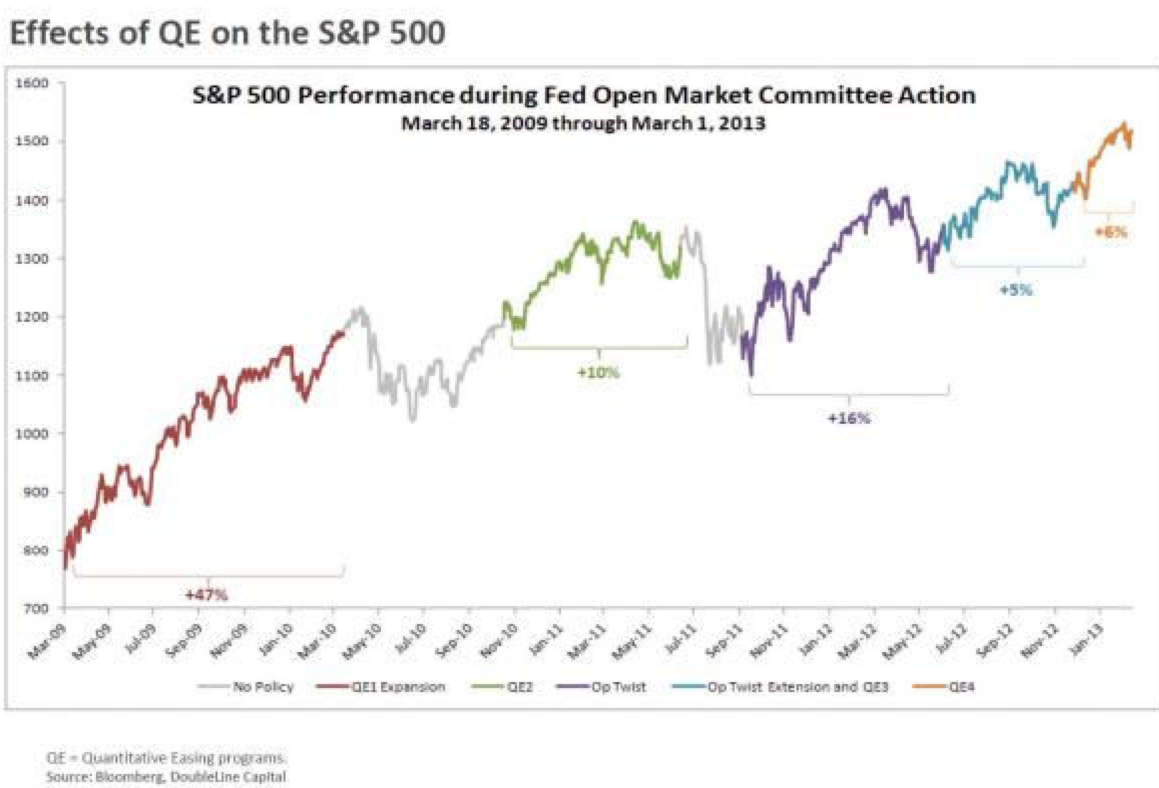
Each time the Fed buys bonds, it pushes up the prices of bonds. The sellers of those bonds have lots of cash – $85 billion per month. A difficult question is where is all that cash going? Some has perhaps been spent; others gone to banks, or reinvested in other financial markets. Wherever this huge sum of cash is getting injected, those assets are likely artificially high. So, when the bond-buying program ends, I'd expect some sectors of financial markets to fall.

Wherever that cash went is now artificially high. Thus, when the bond-buying program ends, I'd expect some sectors of financial markets to fall.

What are QE's impacts on stock prices?

This question is highly debated, and, answers range from "[not much]" to "[500 points]" (implying a 30% drop in stock prices). I haven't found a satisfying answer. Investors certainly react strongly every time a new clue about QE is given.

The following graph shows that QE is correlated with higher stock prices. And when QE ends, stocks have the tendency to fall.



I don't want to over-sell this graph. QE has probably helped the stock market, but the stock market has also gone up due to tremendous improvements in the economy. The Fed is aware that QE has moved stock markets up, and is trying to exit QE as smoothly as possible.

Some sectors of the stock market behave "bond-like" and I believe those have gotten an artificial lift from QE. These are stocks that behave like bonds in the sense that they pay high dividends but are growing slowly. Examples of areas I believe were lifted from QE include utility stocks, REITs (Real Estate Investment Trusts), MLPs (oil pipelines for example) and "defensive" stocks (Proctor and Gamble is an example: their earnings are relatively independent of the economy). So I've been avoiding these assets with the belief that QE has pushed up their prices.

When will QE end?

I would argue this is unknown, even to the Fed itself. When QE was originally announced in 2008, the Fed said it would end in "a few quarters." Five years later, the Fed is again suggesting that QE might end in a few quarters.

Between 2008 and now, they've halted, restarted, twisted, expanded, and contracted QE. The Fed is responding to economic data and their own economic forecasts. So far, the Fed's forecasts have been too optimistic, which explains why QE has gone on too long. Ben Bernanke himself can't predict when QE will end, so, I don't think it's fruitful for me to try. And the other members of the Fed often have completely different outlooks on QE and the economy:

Federal Reserve Bank President of Dallas Fisher wanted to end QE in 2011: "No further accommodation is needed after June [2011]."

Federal Reserve Bank President of St Louis Bullard said "to maintain credibility, the Committee must defend its inflation target when inflation is below target" – which means he wants QE to continue indefinitely.

The latest comments from the Fed suggest a "tapering" of QE might begin later this year. I plan on holding cash in advance of that tapering, to see any bargains that may come along.

I hope I've given a flavor for the issues surrounding QE – there is wide dissent on QE. The Fed itself has widely differing views. Fed analysts also have varying analysis on the impact of QE. With each new data point, I think markets will move, and in that process I think bargains will surface. I have bumped up cash levels to take advantage of any opportunities that may arise.