



Quarterly Letter December 2013

Written December 24th, 2013

THALASSA CAPITAL LLC

"The stock market is filled with individuals who know the price of everything and the value of nothing." Phillip Fisher

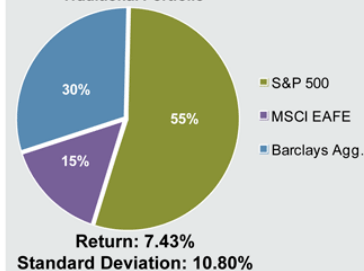
As famed investor and author Phillip Fisher reminded us many years ago, understanding the intrinsic value of an asset is one of the keys to long term successful investing. Regrettably, financial markets are filled with participants that forget the importance of research and applied common sense. Most average investors are plagued by many behavioral biases that ultimately impair performance and eventually lifestyles.

A study conducted by JP Morgan illustrates this fact rather eloquently: the average investor, in the 20 year period from 1993 to 2013, has gained an average annualized rate of return of only 2.3% versus an annualized return by the S&P 500 of 8.2%. Even more sadly, the average investor did not even beat the inflation rate which burned people's purchasing power at a rate of 2.5% per year.

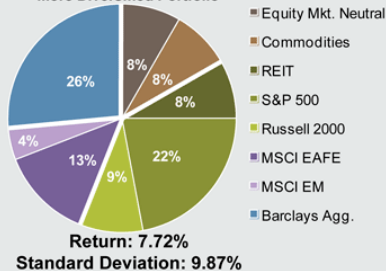
The following table shows the annualized rate of return for the last 20 years for different asset classes, inflation, the average investor, a diversified portfolio and a traditional stocks and bonds portfolio. The table also includes a measure of risk defined by the standard deviation for the two sample portfolios.

Maximizing the Power of Diversification (1994 – 2012)

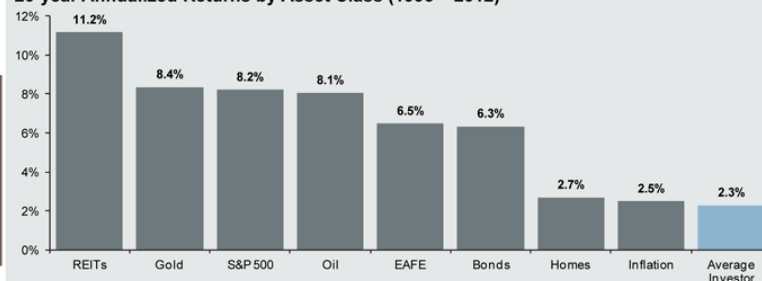
Traditional Portfolio



More Diversified Portfolio



20-year Annualized Returns by Asset Class (1993 – 2012)



(Top) Indexes and weights of the traditional portfolio are as follows: U.S. Stocks: 55% S&P 500; U.S. Bonds: 30% Barclays Capital Aggregate; International Stocks: 15% MSCI EAFE. Portfolio with 25% in alternatives is as follows: U.S. Stocks: 22.2% S&P 500, 8.8% Russell 2000; International Stocks: 4.4% MSCI EM, 13.2% MSCI EAFE; U.S. Bonds: 26.5% Barclays Capital Aggregate; Alternatives: 8.3% CS/Tremont Equity Market Neutral; 8.3% DJ/UBS Commodities; 8.3% NAREIT Equity REIT Index. Return and standard deviation calculated using Morningstar Direct. Charts are shown for illustrative purposes only. Past performance is not indicative of future returns. Diversification does not guarantee investment returns and does not eliminate risk of loss. Data are as of 9/30/13. Guide to the Markets – U.S. J.P. Morgan Asset Management. (Bottom) Indexes used are as follows: REITs: NAREIT Equity REIT Index, EAFE: MSCI EAFE, Oil: WTI Index, Bonds: Barclays Capital U.S. Aggregate Index, Homes: median sale price of existing single-family homes, Gold: USD/Troy oz, Inflation: CPI. Average asset allocation investor return is based on an analysis by Dalbar Inc., which utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior. Returns are annualized (and total return where applicable) and represent the 20-year period ending 12/31/12 to match Dalbar's most recent analysis.

J.P.Morgan
Asset Management

The take-away from this study is the importance of smart diversification and the adherence to a well-constructed investment plan. Both of these elements are driven by proper valuation analysis and projections of risk and expected returns.

As we look forward to 2014, we should try to identify areas of heightened risk and other pockets of possible opportunities. The last twelve months have surprised most investors for the significant outperformance of domestic equities. A return of approximately 25% (as of this writing) was not expected; at the beginning of 2013, equities did look as a favorable bet based on absolute metrics of valuation and in relative terms to bonds. However, earnings grew at a slow pace, the fiscal debate continued to be an element of uncertainty and the Federal Reserve started to remind us that Quantitative Easing is nearing its end. This situation created a disconnection between the growth of fundamental variables and the rise in equity prices. This contingency has produced a market that seems pricey going into 2014. The P/E ratio for the S&P500 is slightly above its historical average of 15 and the forward P/E is just around average levels; however, the forward multiple has increased by 50% in the last two years. P/E multiples expansion is accounting for approximately 80% of this year index return and it is unlikely to continue to support equities in this fashion next year.



What this means is that further increases in equities should come mostly from earnings growth rather than multiple expansion. Earnings are expected to grow in the 5%-10% range next year and most strategists are pinning their 2014 market forecasts around those levels.

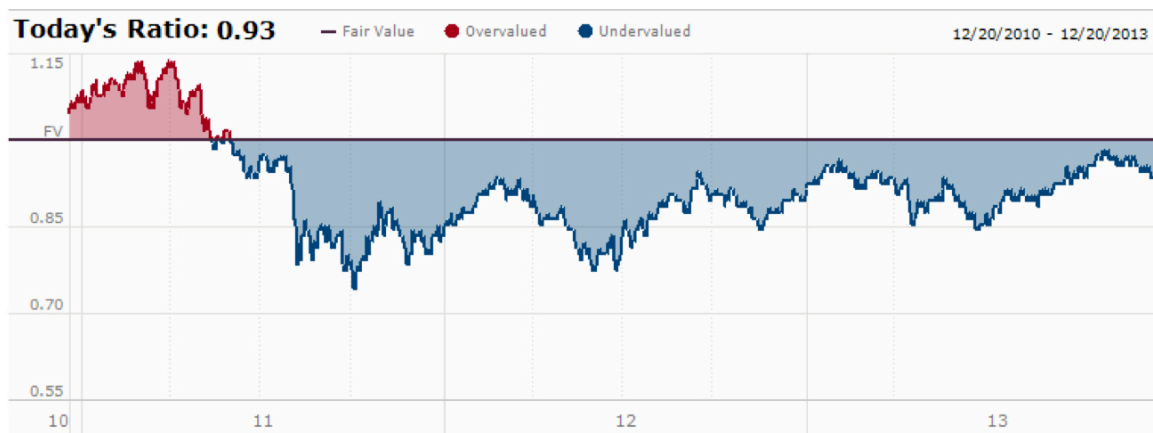
What could materially change such expectations? Conceivably, we could see a melt-up in stocks in the first few months of the year if a possible convergence of a stronger than expected economy and a major re-allocation from bonds to equities were to take place. We give this scenario a low probability given present valuations and the fact that the large increase in the S&P 500 this year has, most likely, already tilted most institutional portfolios toward an overweight in equities.

A negative scenario could materialize as the result of a mismanaged exit from Quantitative Easing (which is going to start in January) or a mismanaged change of the baton at the Fed as Ben Bernanke should be succeeded by Janet Yellen. A less vigorous economy could also hit the bottom line and provide a catalyst for some significant profit taking.

All considered, we expect some volatility to come back into the market in 2014. Investments in equities should be selective and opportunistic and probably more alpha driven rather than pure passive beta.

Energy

The energy sector is one of the few areas that is not showing overvaluation but it is actually trading at interesting levels. The following graph provided by Morningstar shows how the sector is still undervalued, albeit less than twelve months ago.



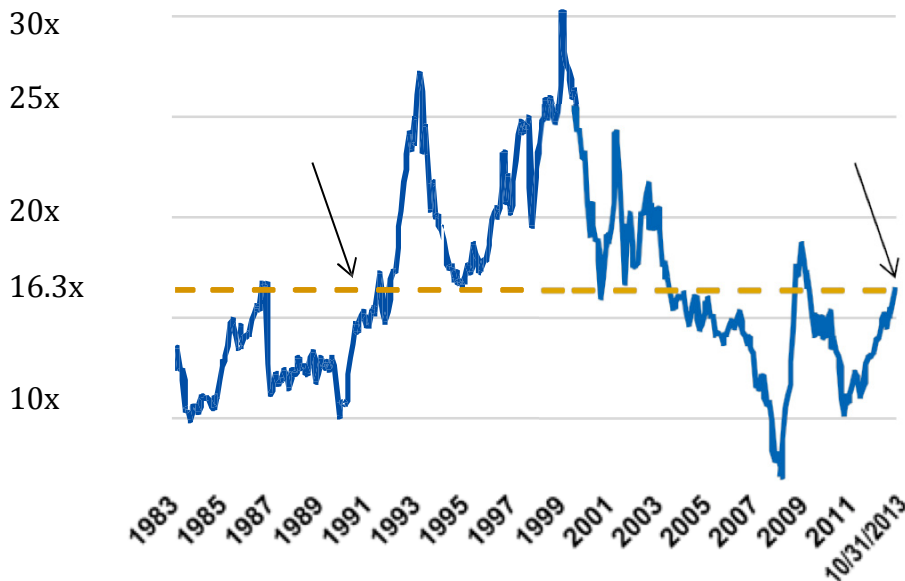


The market is probably implying an overly bearish outlook on the price of crude oil. WTI is currently trading at \$99 and Brent at \$111; while large increases in production in the U.S. will continue to put pressure on WTI, it must be noted that these increases are coming from unconventional resources which have a fairly high break-even price to make extraction economically feasible. Gulf countries (with probably the exception of Iran) have also high break-even levels due to fiscal policies. This situation translates into a probable trading range for both oil benchmarks of approximately \$10 up or down from current levels.

Master Limited Partnerships are in a situation similar to general equities. Their current valuation is fair while the longer term outlook remains very much positive. Yields are still generally attractive but an increase in exposure to this asset class should come selectively.

Europe

MSCI Europe Index Price to Earnings Ratio





When we launched our Europe Value portfolio, European equities were trading at a generational low valuation. Plagued by a sovereign debt crisis, the common currency was put in doubt and negative economic growth held back the continental periphery. Things have improved since then and even after a good run, European stocks are still attractively valued in absolute terms and in relative terms to U.S. equities. The chart above illustrates our point as it shows the MSCI Europe P/E Ratio (blue line) versus the average MSCI Europe P/E Ratio over the last 30 years. The current ratio is now at 16.3, exactly in line with the historical average. This value is in contrast with the 2012 lows of just above 10 but a far cry from previous peaks between 20 and 30 times earnings.

An increase in economic growth and a Central Bank which is expected to remain less hawkish than the Fed should continue to support an expansion of multiples in Europe.

Fixed Income

We retain a negative outlook on bonds long term as monetary policy normalizes and inflationary pressures will eventually build up in the system but we do recognize that as the interest rate outlook changes, pockets of opportunities will become available. In most of our asset allocation models, we underweight bonds but we are scouting for attractive dislocations such as seasonal opportunities in closed end funds, selective opportunities in municipal bonds (which had their worst year in nearly two decades) and hedging strategies.

Commodities

Commodities especially are an interesting play at this stage. They clearly underperformed since their peak in 2008 as measured by the CRB Index. This index dropped over 30% since then, industrial metals dropped almost 60% and gold is now down close to 40% since its peak in 2011.

Is the commodity super-cycle dead? A report by McKinsey and Co. recently made some positive comments on this subject indicating that the generational super-cycle should still be intact. The consultancy group highlights how in nominal prices commodities are still above the levels they were trading at the beginning of the cycle (2000) and it believes that in spite of the recent improvements in production and extraction, demand will again outstrip supply as Emerging Markets continue to expand.



Additionally, from an allocation perspective, a Merrill Lynch survey of institutional managers indicates a level of under-allocation to commodities similar to the early 2009 bottom, a clear contrarian signal.

REITS

REITs have been a popular portfolio diversifier in the past 20 years and provided a quick and cost effective way to enter the inherently illiquid commercial real estate segment. Its diversification character and its high pay-out ratios also made the segment a favorite of income investors.

However, REITs do tend to be volatile and in recent years their short term correlation to equities has increased. Nevertheless they remain an attractive component of any well diversified portfolio. In 2013, they first outperformed the market as more and more funds flowed into high income generating investments and then they significantly underperformed as the Fed announced a coming end to QE. The correction created some good opportunities especially in niche sectors where some of the yields are now compelling. On the global front, there are opportunities in Hong Kong real estate which seems to be trading at a discount to historical valuations.

REITs, in the short term, may continue to face headwinds from the unwinding of QE but we think they are a valuable component of long term portfolios.

Conclusions

In conclusion, we expect 2014 to be a year of higher volatility, where opportunities will occur selectively in most asset classes. Discipline, diversification, long term horizon and a contrarian approach will remain pivotal elements of our overall approach to portfolio construction.

We look forward to managing your wealth in 2014 and we feel honored to have gained your trust.

Happy holidays from your investment team!

Youri Bujko

Davide Accomazzo