MJB ASSET MANAGEMENT

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Richard Bregman, *Chief Executive Officer*

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Dear Clients and Friends:

One day back in mid-December, I went out for a morning jog before heading to the office. An hour later, I arrived at my desk, sat down and then stood up to greet a visitor—and was met with excruciating pain in my left knee. It turns out I had torn the meniscus cartilage in my knee and would require arthroscopic surgery to alleviate the pain. Arthroscopic meniscus repair is an outpatient procedure with a 98% success rate and I was to be operated on by an excellent surgeon who specializes in knees at a well-known New York hospital. Nevertheless, 98% is still two percentage points shy of a sure thing, and I soon began having what I call "catastrophic fantasies": the mental magnification of low probability events into high probability calamities. In this case, my fear was that the surgery, notwithstanding its historically high rate of success, would go horribly wrong.

We all have fear-based fantasies from time to time. As investors, we might magnify normal market movements into visions of total and permanent loss.[1] Investors, as do all fantasizers, have a choice: 1) ignore the fantasy (and recognize that temporary drops are a normal part of investing); or 2) yield to the fantasy (and sell at a point that transforms a temporary market decline into a permanent investment loss). I understand how challenging it is for many investors to ignore the fantasy; I also know the consequences that arise from giving in. During my knee surgery (I chose to ignore my fantasies), I was under general anesthesia and could not act on my fears by yelling "stop!" at the first sign of pain and getting off of the operating table. Investors, however, can "get off the table" any time they want by selling their portfolios. Unfortunately, "any time" often turns out to be the worst time – when markets are at or near temporary lows.[2]

For that reason, at MJB Asset Management, we structure our portfolios to minimize the type of price movements that trigger catastrophic fantasies. We do this in two ways:

1. We liberate our portfolios from the uncertainties of the markets by utilizing investment strategies that hedge against severe market movements.
2. We allocate our portfolios flexibly to opportunities that we believe offer compelling values in the current investment environment, rather than using rigid, pre-programmed allocations

[1] For investors with properly diversified portfolios, the fantasy of total permanent loss is truly a fantasy, as it would require *every company in your portfolio* to go bankrupt or for some other reason be valued at zero.
[2] The flip side is periods of consistently rising prices that spark fantasies of unlimited gains, leading investors to buy markets at their peaks, e.g., buying grossly overvalued internet stocks in June 2000 or housing-bubble-inflated financial stocks in October 2007. Such unrestrained euphoria is the front half of the "buy high, sell low" cycle that bedevils many investors.

among stocks and bonds based on historical analysis or guesses about the future. As investment conditions and valuations change over time, we change our allocations.

As a result, our portfolios simultaneously take advantage of current investment opportunities while hedging against unseen turbulence that can shake markets and investor confidence.

The Current Investment Environment

The bull market in bonds that has been running since early 2009 is largely over. Inflation is on the rise and is a bond's enemy: prices rise while a bond's interest payments do not, thereby making the bond's interest payments less valuable.[3] Though government reports say inflation is almost non-existent—thanks in part to the official exclusion of food and energy prices from government calculations—investors beg to differ as they pay higher prices for most items, including those in the supermarkets and at the pumps. As a result, investors are finding bonds less desirable and are beginning to sell, leading to a decline in bond prices. Facing that headwind, we have reduced our bond holdings.

The inflationary forces driving the bond market are also affecting global stock markets. While the U.S. Federal Reserve denies the re-emergence of inflation and continues its easy money policies (i.e., keeping short-term interest rates low and flooding the market with U.S. dollars through its Quantitative Easing program), the rest of the world — particularly the emerging markets — is tightening, either by raising interest rates or by restricting the flow of money into their economies. As emerging market governments act to slow their overheating economies, monies are flowing from those markets back to markets in the developed nations. Consequently, we are weighting our stock fund holdings more heavily toward the U.S. and developed European markets.

Comments on Hedging Strategies

Though the risk of tearing a meniscus cartilage is always present while running, I had no idea it would happen on that particular December day. Similarly, markets always have risks. Some are in plain view; others are unseen, akin to turbulence in the air or water. In the several days that I have been composing this letter, we have seen severe upheaval and violence in the Middle East and a devastating earthquake and tsunami in Japan. My heart goes out to anyone directly affected by these tragedies. From an investment standpoint, I do not know the extent to which those events, or other unseen risks will lead to a market disruption. To help protect against such risks, we place at least one-third of every client portfolio in funds utilizing sophisticated hedging strategies that do not depend on market movements for their returns. When events occur that trigger investor fantasies and lead to market sell-offs, the hedging strategies should help limit the downside to our clients' portfolios. Sell-offs typically create opportunities as well; by limiting our downside, we are well-positioned to participate in ensuing upturns.

Thank you for your continued support. Please feel free to contact me if you have any questions about your portfolios or if you have had a change in your investment goals.

Sincerely,

Richard Bregman

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[3] In 1948, a subway ride cost one nickel; a dollar bought twenty rides. Today, the fare is $2.25; the same dollar buys less than half a ride.