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"It was one whale versus another whale."
– Anonymous hedge fund manager, *New York Times*, "The Hunch, the Pounce and the Kill," (May 26, 2012)

"We have to remember that this is not our money. Do not confuse yourself with your customers' commissions ... that's a sacred trust."
– Susan Byrne, retired mutual fund manager, speaking at the Morningstar Conference, Chicago, IL, June 21, 2012

Dear Clients and Friends:

A few weeks ago, I flew to Los Angeles to attend a research meeting with a fund company. The in-flight movie was "Big Miracle," an uplifting dramatization of a true Cold War era story about a U.S.–Soviet–Greenpeace collaboration to rescue three whales trapped under the Arctic ice cap in Barrow, Alaska in 1988. The story received international interest because, as one of the news editors was said to have commented at the time, "Everyone loves whales."

It turns out that the finance industry, too, has whales, though not necessarily the type that everyone loves. In financial circles, a "whale" is an enormous, difficult-to-conceal and difficult-to-undo trade and/or the trader who has made an outsized bet. The anonymous quote at the top of this letter refers to Bruno Iksil of JP Morgan and Boaz Weinstein of Saba Capital Management, the two whales on opposite sides of a gargantuan derivatives trade that has left JP Morgan with a loss exceeding $2 billion and Saba and other hedge funds with corresponding gains. What's $2 billion to a firm the size of JP Morgan? JP Morgan stock dropped roughly 25% in the weeks following the loss;[1] the people immediately responsible for the trade "resigned"; and JP Morgan CEO Jamie Dimon – after blithely characterizing the trade as "a tempest in a teapot" – was summoned to testify before Congress on what went wrong.

[1] The S&P 500 Index declined by 6% during the same time.
[2] In this case—as there is no actual "JP Morgan" money—the funds were entirely sourced (and lost) from shareholders. JPM failed to differentiate between the risk it allowed its managers to take and the risk that was appropriate for its shareholders.

Ultimately, and notwithstanding the testimony about "risk management" from Mr. Dimon – a rock star in financial and political circles – the answer to the question of "what went wrong" lies in the second quote above from Susan Byrne, a retired fund manager and current chairperson of Westwood Holdings, a smaller yet still publicly owned financial firm: JP Morgan breached the "sacred trust" that shareholders placed in it to differentiate between its own and their money.[2] In effect, Mr. Iksil was playing with other people's money. He, his superiors, and all of the risk managers who somehow failed to grasp the nature of the trade and its potential risks to the bank and its shareholders had none of their personal wealth at stake.[3,4]

We do not pretend to know why Mr. Iksil and/or his superiors made the bet or how differently they might have acted had they had their own money at risk. However, we do know that having "skin in the game" can be a powerful incentive for people to consider all of the potential consequences of their actions. At MJB Asset Management, we consider it a critical factor when deciding whether to entrust a mutual fund manager with our clients' monies. We ask fund managers if they have any of their personal wealth in the funds they manage; if the answer is anything other than "yes," we look elsewhere. Though not a guarantee of performance, it surely indicates they are paying attention to what they are doing and are prepared to take responsibility for the consequences of their investment decisions. In short, it is a measure of integrity. And that is what the "sacred trust" is all about, not just among individuals charged with stewardship of other people's money, but in all areas of our lives. We embrace the "sacred trust" not only in the way we search for top quality managers, but also in the way we serve our clients: we invest side by side with all of our clients — we will not place any security or fund in a client portfolio unless we own it in our personal portfolios as well. In this way, we share with our clients the pains as well as the gains that come from our decisions when investing in unpredictable markets.

To characterize investment markets as anything other than unpredictable would be something of an oxymoron. The events that impact investors' decisions to buy and/or sell are unpredictable, as are the ways in which investors will react to such events. Given our twin goals of both creating and preserving wealth, we consider it imperative to protect our clients' capital against the unpredictability of the markets. Thus – unless a client specifically instructs us otherwise – we invest at least one-third of every portfolio in funds that pursue hedging strategies, i.e., strategies designed to blunt downward market movements or to seek gains independently of market movements. Over time, the consistent protection of capital during down periods adds up to consistent longer term gains. More importantly, it reduces the stress associated with large – though ultimately temporary – declines in value during bear markets, which in turn enables investors to make more reasoned decisions during such times of increased market volatility.

Little has changed in the past few months, as all eyes remain on Europe and its leaders' abilities to hammer out an agreement that will keep the Euro intact and restore fiscal credibility to the weaker peripheral European states. In the U.S., interest rates remain low, unemployment remains high and economic indicators increasingly point to a stall in the already tepid U.S. economic recovery. Against that backdrop, global stock markets generally dropped anywhere from 3% to 6% this past quarter. As always, we look for values wherever they occur within the current environment. Currently, the strongest risk/return equation favors large multi-national dividend paying stocks. The strongest pure valuation plays are high quality stocks in the Euro zone, though it is still very early in that game and the risk

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[2] In this case—as there is no actual "JP Morgan" money—the funds were entirely sourced (and lost) from shareholders. JPM failed to differentiate between the risk it allowed its managers to take and the risk that was appropriate for its shareholders. Query whether any Morgan shareholders knew of the trade in advance or – assuming they were sophisticated enough to understand the complex nature of the trade – would have approved of it.

[3] The same is not true for Mr. Weinstein, who is the general partner in Saba and as such has a personal stake in the investments that he makes. Saba's "shareholders" (technically, limited partners in the hedge fund structure) are paying Mr. Weinstein to take exactly the type of risk that he took in making the trade.

[4] Ironically, or perhaps typical in the world of Wall Street, Mr. Weinstein was once in Mr. Iksil's shoes. In 2008, while employed by Deutsche Bank, Mr. Weinstein made a disastrous trade with bank money that led to a loss in excess of one billion dollars. He left shortly thereafter to form Saba Capital.

remains high (but think back to the U.S. markets in late 2008 and early 2009 for a view of the potential growth waiting in the prices of such European stocks).

Back to our whales – the ones in the ocean, not the trading floor. Even though they had made the migration from the Arctic to warmer waters every year, in 1988 they somehow got trapped. Figuratively speaking, the whales did not leave themselves an "out" and would likely have died, but for an improbable bailout resulting from a mix of love, politics and manpower. And though Wall Street whales, too, receive bailouts through politics (i.e., the taxpaying public), individual investors such as you and I do not. That is why, in addition to seeking investment gains from the above-mentioned investment opportunities, we will continue to hedge against the potential loss of capital in these markets.

Thank you for investing with MJB Asset Management. I wish you the very best for the summer!

Sincerely,

Richard Bregman