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Richard Bregman, *Chief Executive Officer*

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Dear Clients and Friends:

In the spring of 1974, with my high school graduation approaching, my parents took me to procure a tuxedo to wear to my senior prom. Thirty-nine years later, styles have changed[1] but the tradition has not: earlier this summer, my wife and I took our son to find a tux for his prom. We faced the same choice as my parents: we could rent or buy. Renting is less expensive up front; buying offers a longer-term benefit for the extra cost, though it might not be pragmatic for an 18-year old who might outgrow it within a year or two.[2] After weighing the pros and cons, we chose to rent.

The standard process is to go to a men's clothing store – in our case, Men's Wearhouse – and select a tux from a catalogue. Men’s Wearhouse maintains its tuxedoes in a large storage facility in Houston. A salesperson in the local store "fits" the renter into a suit that approximates the style and cut of the catalogue tux and sends the measurements to the storage facility, where the catalogue model tux is pulled off the rack in the renter’s size and hemmed to the proper measurements. The now “fitted” tux is sent up to the local store, where the renter picks it up, tries it on and, if it fits, takes it home to wear to the event. In our son's case, however, the tux that arrived did not fit at all – it barely resembled the tux from the catalogue – and no amount of altering was going to make a difference.

Investors refer to the risk of getting something different from what they expect as “benchmark risk.” In this case, the “benchmark” was the tuxedo in the catalogue; the “benchmark risk” was the possibility that the look and fit of the tux that arrived would differ from the look and fit of the tux in the catalogue. In investing, benchmarks are typically an index, frequently the S&P 500 Index of large U.S. stocks. The benchmark risk is that your portfolio performs very differently than the benchmark against which it is measured. For example, if your portfolio is "benchmarked" to the S&P 500, and over the course of, say a year, the S&P 500 goes up by 10% and your portfolio only goes up by 3%, something is not copacetic. Either: 1) the portfolio manager is not doing what he/she says they are doing (e.g., they are investing in overseas stocks as opposed to large cap U.S. stocks); and/or 2) they are doing what they say they are doing but a short-term, one-off event takes them away from benchmark performance (e.g., one of their holdings has an unexpected loss and the stock temporarily drops in value); and/or 3) the S&P

[1] I wore a powder blue Edwardian-style monstrosity with a cummerbund and ruffled shirt.
[2] I no longer fit into the tuxedo I bought for our wedding 24 years ago, but that is a different story altogether!

500 is not the appropriate benchmark for the portfolio (e.g., your portfolio has 50% in bonds by design and thus should not be compared to a 100% stock index).

Going back to our tuxedo story, having suffered benchmark risk[3], we needed to find a tuxedo that fit, notwithstanding that it was way too late to re-do the measurements and get a replacement from the Houston facility in time for the prom. In short, we needed a new course of action in the moment. We engaged the store manager in discussions; combining a dose of customer service with the creative use of bonus points from prior purchases, the manager offered us a tuxedo for purchase and fitting by the store's tailor at the same price as the rental. In effect, the environment for owning suddenly became more favorable than renting, and we took advantage of the change. In the investment world, our decision was akin to changing a portfolio in the face of changing investment conditions and valuations.

Your second quarter reports are in the mail. Performance results reflect both benchmark risk and a shifting investment environment. With respect to the investment environment, it is abundantly clear at this point that bonds no longer offer attractive returns relative to their risks. Interest rates have begun to rise, which mathematically requires bond prices to decline, as the Federal Reserve has begun signaling that its program of bond purchases (generally referred to as Quantitative Easing) is nearing its end. No one knows exactly what this will mean for bonds, which itself is a sufficient reason to avoid owning them. My father-in-law had a saying when facing a situation that others would undertake but that he perceived to be unrewarding: "You go, I'll wave." That is exactly how we feel about most parts of the bond market right now. Many investors, for various reasons, choose to or are required to continue to buy and hold bonds;[4] we face no such restrictions, and have access to other strategies seeking conservative returns that are less likely to be as impacted by rising rates as will be bonds. And so we have been repositioning client portfolios away from the riskier parts of the bond market and in some cases completely out of bonds. Notwithstanding our repositioning, the bond market has taken a toll on investors recently – dropping more than 3% for the year-to-date – and thus has held down our client portfolio returns in the first half of the year.

That brings us to benchmark risk. We have historically measured our client portfolio performance against the S&P 500 Index of large U.S. stocks. However, virtually none of our client portfolios are invested 100% in U.S. large cap stocks. Far from it. We have always been multi-asset class investors. We mix stocks (large, small, domestic and non-U.S.), bonds and hedging strategies into portfolios designed to create consistent returns that do not mimic the returns or the volatility of the U.S. stock market. Our approach will at times lag the returns of the S&P 500 and at other times will handily outperform it. However, whether we are beating it or trailing it – and we have done both over the past few years – the S&P 500 is not an accurate yardstick against which to measure our client portfolios. As such, beginning with these reports, we are no longer benchmarking our portfolios to the S&P 500 Index. We are in the process of constructing a more appropriate benchmark and will have more to say on that topic in future letters to you.

In the meantime, we continue to seek consistent positive returns by investing where we see greatest value and avoiding those areas where we do not see attractive risk/return characteristics. Right now that means moving out of bonds and into conservative stock strategies and conservative hedging strategies in the stock market. For clients who require income from their portfolios, we have continued to

[3] Perhaps someone in the Houston facility made a one-off error picking the wrong style off the rack.
[4] E.g., corporate and municipal pension plans and many educational and charitable endowments adhere to consultant-driven investment policy statements that require significant allocations to fixed income holdings.

hold higher yielding bonds and have replaced funds that we believe have excessive risk exposure with other income generating investments, including Master Limited Partnerships and in certain cases, preferred stocks.

As always, we invest side by side with you and make the same changes to our personal holdings as we do to our client portfolios. My door (and phone line, inbox, etc.) is always open and I invite you to reach out with any questions, comments or concerns, as I always look forward to hearing from you.

Thank you for investing with MJB Asset Management. I wish you a wonderful remainder of the summer!

Sincerely,

Richard Bregman