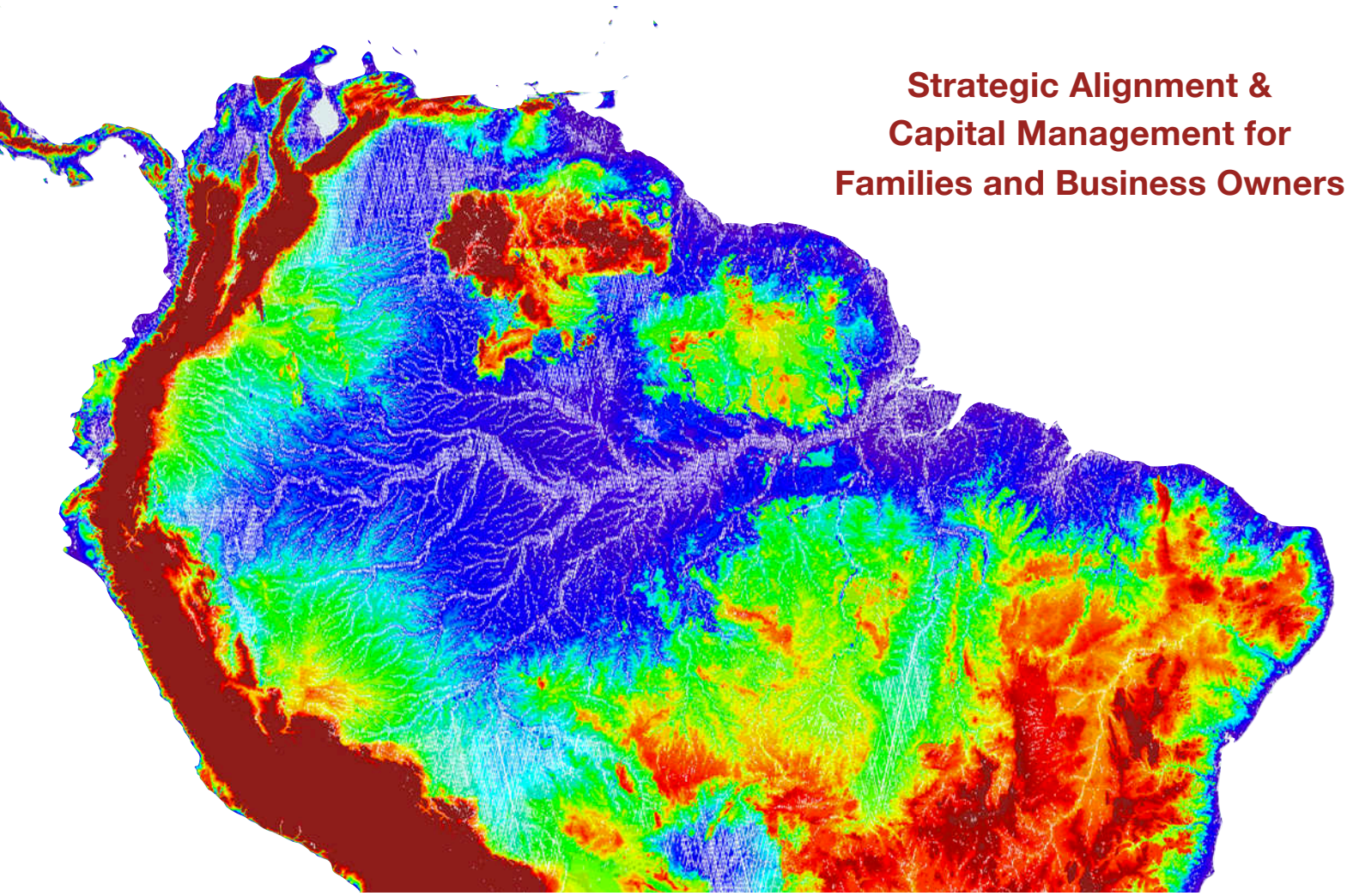
Q2 NEWSLETTER

JULY, 2014

PILOT WEALTH MANAGEMENT

Strategic Alignment & Capital Management for Families and Business Owners



As recently as 10 million years ago, the Amazon river actually flowed east to west. At the base of the northern Andes, it formed a large lake that eventually flowed north into the Caribbean Sea. Over time, it reversed course as the continent tilted and sediment built up. If the largest river on the planet can change directions - couldn't the stock market?

Quarterly Commentary: Everything Changes...Eventually

By Nick Fisher, Portfolio Manager & Principal

A human behavior that magnifies risk during market cycles is Recency Bias. Investors get very excited after a couple of years of great returns. Looking in the rear view mirror of the recent past, they see their neighbor making money and knowing full well that the neighbor is not endowed with any particularly unique intelligence; they too pile into investments they know little about, pushing the prices up and ignoring the underlying fundamentals. And boy have investors piled on!

In This Issue:

Past newsletters can be found at www.pilotwm.com

To illustrate, let us look at S&P 500 returns for the last few years (shown at right). With returns like this, who wouldn't want to be invested in the highest flying US stocks? This trait is not limited to the average investor, however. Recency bias also impacts pension fund managers. A couple of extreme historical examples: In 1972 the average pension fund was nearly 100% invested in stocks, only to get clobbered over the next two years of the stock market crash. Conversely, in 1981 pension funds had a mere 9% allocation to stocks and missed one of the best opportunities to own stocks. The recent past clouded their objectivity and caused extreme reaction. We caution our clients to remain objective.

S&P 500 Returns[1]:

2012	13.29%
2013	29.60%
2014 (year to date)	~7%

History tells us that the market does not go up every year; in fact the market has experienced significant periods of time where very little total return is available. In the 20th century (from 1900 – 1999), for 56 ¼ of those years the market returned a negative total return. Over the 43 ¾ years the Dow Jones Industrial Average went from 66 to 11,000 a 180X total return (turning $1,000 into $180,000). Further, long stretches of time passed where very little if any return was created. Consider from 1900-1921, the market returned 26% (less than 0.5% per year). From 1929-1948, the market returned a negative 52%. From 1965-1981 the market returned virtually zero. As comparison, recalling the headlines in 2009, the "lost decade" doesn't seem so bad.[2]

Stock market returns have a very low correlation to economic growth. The economy grew during every decade of the 20th century. In fact, the decade of the greatest economic growth was during one of the time periods of the most dreadful stock market returns (1940s). The simplest explanation for these paltry returns is plainly the starting point of valuations. Extreme, above average valuations are followed by periods of low return.

Someday, the winds of change will again shift. Renowned investor Seth Klarman summed it up very well in one of his recent letters to his investors:

> Someday, financial markets will again decline. Someday, rising stock and bond markets will no longer be government policy. Someday, QE will end and money won't be free. Someday, corporate failure will be permitted. Someday, the economy will turn down again, and someday, somewhere, somehow, investors will lose money and once again come to favor capital preservation over speculation. Someday, interest rates will be higher, bond prices lower, and the prospective return from owning fixed-income instruments will again be roughly commensurate with the risk.[3]

In the meantime, we search high and low for any semblance of reasonable risk adjusted returns. In contrast to US markets, many markets internationally currently sell for a much lower valuation. We would advocate allocating a sensible amount of capital toward these areas. According to Mebane Faber, US investors currently have very little exposure to international markets and some international markets currently sell for less than half the valuation as in the US (see our recent Chart of The Week: 5/20/2014).

"The mental rules of thumb that evolution gives you to deal with risk are not adequate."
-- Charlie Munger

We believe that investors willing to take the unconventional approach of allocating a greater percentage of capital toward international markets (selling at reasonable valuations) will be rewarded with better comparative risk-adjusted returns. This is not to say we will forget about the US market, as the opportunity to invest at lower prices will surely present themselves again, someday.

[1] Morningstar and Wikipedia
[2] Buffett, Warren. Speech at the University of Georgia.
[3] Klarman, Seth. Letter to Investors

The Cost of Not Getting It

By Rick Thomas, Business Advisor & Principal

While I am not a fan of reality TV, I have to confess my devotion to a couple of shows that have an entrepreneurial bent – ABC's *Shark Tank* and CNBC's *The Profit*. In S*hark Tank*, aspiring entrepreneurs pitch their products to a panel of successful investors, aka the sharks, to hopefully gain their investment. In *The Profit*, Marcus Lemonis, billionaire CEO of Camping World is brought in to assess the viability of a failing business. If he determines it is worth saving, he invests in the business and proceeds to implement a rapid turnaround employing his principles of people, process and product. As you might imagine, the interesting TV is when he encounters resistance to his efforts to change how the business is run. Reality drama aside however, both shows are a study in competency, business model execution, and commitment of the business owner or would-be-entrepreneur. What I have noticed from watching episodes of both shows is a common description Lemonis and the Sharks use to describe someone who is failing; they are someone who just doesn't get it.

At some point I adopted the use of this phrase and have used it to label a condition where the business owner or employee is clearly failing. But what does it really mean, to not get it? And more to the point, what if I'm the one not getting it? In the case of the TV shows, the price is high. A savvy investor will smell out someone who doesn't get it in a heartbeat, leaving the entrepreneur failing to gain the investment in his or her venture or turnaround. What about for us? What is the price we pay by not getting it?

...our ego will not allow us to see the problem for what it is, while to the outsider, it is as obvious as a bad smell in the refrigerator.

We have to look no further than where we are repeatedly failing due to the same mistakes being made over and over. Whether it is continuing to make bad hires in the organization, finding the business constantly faced with litigation, or repeatedly surprised by a lack of cash flow, each of these ongoing failures are a pattern that indicate how we are not getting it. And in most cases our ego will not allow us to see the problem for what it is, while to the outsider, it is as obvious as a bad smell in the refrigerator.

How much do we ultimately pay for not getting it? It depends on what the goal is, but it is safe to say the impact is the most profound on a growth business. The areas of repeated failure impact the business in substantial ways, ranging from a marginalized valuation to the potential of business failure.

The humility you gain today will be the valuation you will gain tomorrow.

If this is beginning to feel too close to home, take heart. You are not alone. Make the commitment to do something about it. Start with being clear about what the ultimate goal is. Behavior change without knowledge of the "what" and the "why" at stake is, is virtually impossible to do. Then be willing to ask for feedback from a trusted advisor or confidant. Being willing to have your blind spots pointed out is not easy, but will help you do the heavy lifting required to correct bad habits that are deeply entrenched in your neural pathways. It is a humbling experience, but worthy of the desired outcome. Suffice it to say, the humility you gain today will be the valuation you will gain tomorrow.

Investing in the Future

By Jason Lesh, Managing Principal

Founded by Nick Fisher (Portfolio Manager, Pilot Wealth Management) and his wife Maurissa, Young Entrepreneurs Business Week (YEBW) was started in 2005 with a simple vision— to host a summer camp where Oregon high school students could get inspired and learn how to become leaders in the world of business. We were excited when 26 students attended our first Business Week on the campus of the University of Portland, and had high hopes the program would grow in the coming years. Little did we know just how many students we would be able to reach, not only in Oregon, but also from across the country and even internationally!

Since that first camp in 2005, YEBW has grown into a robust program and this year we will host more than 300 students who will attend one of three camps. Students can now choose between Business Week, Investing Week, or Entrepreneur Week held on the campuses of the University of Portland, Oregon State University, or the University of Oregon.

While YEBW has grown and changed over the years, our curriculum continues to challenge even the most accomplished students and our mission remains the same—to build and prepare the next generation of business leaders.

Pilot Wealth Management has partnered with and invested in YEBW to help provide high school students with progressive and immersive programs in the key areas of entrepreneurship, business fundamentals, financial investments, career readiness and leadership development. In addition to serving on the Board of Directors, Nick and Jason volunteer throughout the summer in numerous capacities.

What makes our program particularly strong and appealing is the number of business leaders who volunteer their time or company resources. Nearly 200 volunteers serve as the foundation for our success. They include advisors, board members, speakers, interns, judges and more. Their commitment to these future leaders has made YEBW the best business and entrepreneurship program for high school students in the country.

If your child or somebody you know would be interested in the program, please don't hesitate to introduce them. Meeting the students that attend and witnessing the transformation and growth in one short week is inspiring. Our state and our communities will be in good hands with the leaders that YEBW helps form.

Young Entrepreneurs Business Week

University of Portland, July 20–26
Business Week & Investing Week

Oregon State University, July 27–August 2
Business Week & Entrepreneur Week

University of Oregon, August 10–16
Business Week & Investing Week

503-576-4871
www.yebw.org

Strategic Alignment and Capital Management for Business Owners and Families

Pilot Wealth Management

503-847-9723
503-841-5416
www.pilotwm.com