WOLF GROUP CAPITAL ADVISORS
GLOBAL WEALTH MANAGEMENT

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"Successful investing is anticipating the anticipations of others." – John Maynard Keynes

In response to the 18th century writings of Thomas Robert Malthus, who predicted that starvation would result when population growth exceeded food supply growth, historian Thomas Carlyle coined the phrase, "dismal science." Everyone who has studied economics likely knows his famous quotation, "… a dreary, desolate and, indeed quite abject and distressing one; what we might call, by way of eminence, the dismal science." Economics often receives this kind of label in part due to its dealings with scarcity – the notion that human wants are seemingly unlimited, while the world's resources are limited. Despite this gloomy sobriquet, economics can be fun and rewarding. Even persons unaware of basic economic principles may be employing them on a daily basis. Anyone who shops for bargains probably understands the interplay of supply and demand. Whenever one decides to buy a $5 Caramel Macchiato versus a $1 cup from the local diner, the principle of personal utility is on full display. We recently discovered that one of the most famous economists of all time, John Maynard Keynes, was also a successful investor. Given that economists and investors do not always speak the same language or share similar worldviews, we were fascinated to hear the story of the great economist's adventures in investing.

Fourth Quarter Review

The best word to describe the markets' performance for the quarter might be "mixed." The modest gains seen in many of the indices effectively hide the underlying volatility of the various sectors. Utilities were very strong in the quarter, while consumer discretionary names were much weaker. Biotech stocks, which had been very strong through most of 2013, witnessed aggressive profit taking in the quarter. Commodities, which had lagged most indices, last year staged a strong comeback in the first three months of 2014. Although the markets appreciated only modestly in the quarter, their underlying strength cannot be overestimated. For the equity markets to continue to appreciate in the face of 1) a new Federal Reserve Chair, who is still figuring out how best to communicate policy to the public and 2) Russia's annexation of Crimea is quite remarkable. Flare-ups in the Syrian civil war had a bigger impact on the markets last year than Russia's actions this year. The markets would sometime tumble on Ben Bernanke's use of adverbs, yet they mostly shrugged at Ms. Yellen's sometimes opaque pronouncements regarding her spin on monetary policy. In our view, the returns are very positive given the macro circumstances.

Here is what the first quarter looked like by the numbers:

Index	1st Qtr 2014	Year to Date	Trailing 12 Months
Dow Jones Industrial Average	-0.2%	-0.2%	15.7%
S&P 500	1.8%	1.8%	21.9%
NASDAQ	0.5%	0.5%	28.5%
Russell 2000	1.1%	1.1%	24.9%
MSCI EAFE	0.7%	0.7%	17.6%
MSCI EAFE Small Cap	2.4%	2.4%	22.0%
MSCI Emerging Markets	-0.8%	-0.8%	-3.9%
Barclays Aggregate Bond	1.8%	1.8%	-0.1%
Barclays Municipal Bond	3.3%	3.3%	0.4%
Dow Jones Commodities	7.4%	7.4%	-2.9%

Meet Mr. Keynes

John Maynard Keynes is arguably the most influential economist of the modern era. Often regarded as the father of macroeconomics, his thoughts, theories and words continue to resonate even today. In the 1930s, his work revolutionized economics by suggesting that free markets would not automatically provide full employment, and that state intervention could moderate the boom and bust nature of economic cycles.

He was born in Cambridge England in 1883, to an upper-middle class family. Always a good student, he was awarded a scholarship to Eton College in 1897, where he excelled in a broad range of subjects such as mathematics, history and classics. Although he graduated with a math degree, his interests continued to expand into philosophy, economics, debate and government. After brief stints in government service and academia, he joined the U.K. Treasury. It was here where Keynes' sharp mind and insightful analysis greatly helped his nation endure the financial calamities of World War I. So pivotal was his role that he became the financial representative for the Treasury to the 1919 Versailles peace conference.

The rest of his story is well known to anyone who has studied economics. His *The Means to Prosperity*, which advocated public spending as the cure to unemployment in a global recession, became the handbook for many governments during the Great Depression. His *The General Theory of Employment, Interest and Money*, remains today the gold standard for understanding "Keynesian Economics."

Meet Mr. Keynes – the Investor?

One important and interesting aspect of Keynes' life and career often neglected by biographers is his track record as an investor. Given some of his criticism of the free markets, one might conclude Keynes was anti-capitalism. On the contrary, according to a new book by John F. Wasik, *Keynes's Way to Wealth*, he was a fervent practitioner of capitalism, and was an active investor most of his life. Wasik, from his research, which included looking at thousands of Keynes' brokerage statements and other records, concluded that Keynes was not only a successful investor (but a lousy speculator!), but may be credited with being the father of value investing!

Keynes' early forays into investing (around 1914) not surprisingly, started with his knowledge of international finance by speculating in the currency markets. He thought that his experience and position gave him an edge over most investors, and that his macro view of the world would lead to outsized profits. He started with only a modest amount of money (he lacked any inherited wealth) and began investing via what Mr. Wasik claims to be the first hedge fund. In the first few months, he was able to earn over $100,000, an amazing amount of money for an upstart investment fund. Within four weeks of his great success, however, a turn in the markets wiped out his firm's entire capital.

Undaunted, he turned to the commodities markets in the 1920s. Thinking that rebuilding Europe after WWI would create a supply/demand imbalance for major commodities, he began to trade actively commodity contracts. By 1927, his foresight and analysis enabled him to amass net assets of $3.4 million (in 2013 dollars). By 1928, when the commodity boom began to fade, Keynes found himself long (and wrong) in significant positions in rubber, cotton, wheat and tin. By 1930, he had lost over 80% of his wealth.

His third attempt at investing turned out to be a charm. Instead of trying to predict the direction of asset prices based on macro trends, he focused on company specifics and on intrinsic value. Buying any equities during the 1930s would have qualified him as a contrarian investor, but shunning the short-term emphasis so prevalent then makes Keynes look Buffettesque. This new focus enabled him to outperform the U.K. market (his "home" market) 16 out 18 years from 1929 to 1946. His estate at the time of his death in 1946 was valued at $20 million (in 2013 dollars) suggesting that his prowess as value investor should qualify him as one of the great of the business, and place him in the investor pantheon aside Benjamin Graham, Warren Buffett, John Neff, et al.

Key Elements of the Keynes Approach to Investing

In his book, Mr. Wasik outlines ten key principles he deems fundamental to Keynes' investment style. We were somewhat surprised to find how closely his approach mirrors our own.

1) ***Over time, stocks beat bonds.*** This has been one of the key facets of investing from the very beginning. Yet, occasionally we experience a long period of time (2000-2010) where this relationship appears to the opposite. Any long-term

investor should remember this relationship, especially in those rare times when stocks underperform bonds.

2) ***Speculation is a dangerous game.*** As the old saying goes, "The best way to make small fortune in speculation is to start with a large fortune!" So often investors will buy something because of something they read or heard without understanding the notion of value. Putting money at risk in this fashion becomes speculation. Keynes' conclusion regarding speculation came to him at a high cost.
3) ***Probability is not the same thing as uncertainty.*** Investing is an exercise in probabilities. No matter how precise or accurate one may think an estimate or recommendation might be, nothing can eliminate the uncertainty inherent in the capital markets. Blind adherence to even the most confident forecaster can be a dangerous move.
4) ***Opposed risks will help balance your portfolio.*** In other words, don't put all your eggs in one basket. In normal times, holding non-correlated assets in one's portfolio will reduce its overall volatility. Holding bonds and stocks makes sense for many investors, not to maximize returns (a 100% stock portfolio is more likely to do that), but to lower the volatility (price swings) of the portfolio.
5) ***Take advantage of the value quotient.*** In market declines, many people fear that the market will go to zero. It never does, but that fear can immobilize investors who fail to understand the notion of value. A stock is not a piece of paper or a price quote on a computer screen. It is a piece of a real company that has assets, products, employees, factories, customers, suppliers, earnings and some real value. Buying stocks that trade below this real or intrinsic value is the quest of value investors.
6) ***Dividends don't' lie.*** In the 1930s, stocks were considered so risky that their dividend yields were consistently higher than bond yields. Keynes understood that dividends provide an investor with cash flow that can be reinvested into new stocks trading below fair value. Even now, stocks with above-average dividend yields may be value stocks.
7) ***Don't move with the crowd.*** Easy to say – hard to do. We once saw a survey that showed 80% of investors consider themselves contrarian investors (a mathematical impossibility). True contrarian investors tend to outperform over time and never own the most popular stocks.
8) ***Invest for the long term.*** And this comes from the man who said, "In the long run, we're all dead." Seriously, short-term market movements tell us very little about the long term. Ignoring the chatter about the current state of the markets and investing in companies with solid prospects for the future should lead to above-market returns.
9) ***Invest passively.*** Index funds did not exist during Keynes' investment career. We think Mr. Wasik thought this one up on his own. There is a strong bias in the populist press that no one can "beat the market." Empirically, this is simply not true. Thousands of investors beat the market every year. Many can do it for many years in a row. Perhaps no one can "beat the market" every single year (even Keynes could not do that), but a disciplined, value-oriented, bottoms-up approach to investing can lead to above-market returns in the long run.
10) ***Drink more champagne!*** No one looks back on life and wishes more time was spent working in the office. If you need to look at the value of your portfolio

more than four times a year, you are probably not enjoying life as much as you could. We always find great joy in telling our clients to go spend more money! Life is meant to be enjoyed. Focusing on one's portfolio (whether it is up or down today) is not really living.

Lessons Learned from Mr. Keynes

A number of things impress us about Keynes experience as an investor. First, just being smart does not qualify one to be a good investor. Failing twice as a speculator happened at the same time, he was writing brilliant, career-defining papers and advising world leaders on epoch-defining decisions. Second, he learned from his investing mistakes. The things we hear from so-called market gurus often amaze us – they seem to have no memory of the past and lessons they should have learned from it. Third, we are pleased that his most successful approach to investing synchs up nicely with ours.

We do not speculate. We do not think we would be any good at it. We do not invest using top-down macroeconomic forecasts. We think it is very difficult to make money investing this way. We try our best to be value investors. We understand the idea of intrinsic value and this understanding drives most of what we do are professional investors.

We're all Keynesians Now

Nearly seventy years after Keynes' death, we find ourselves still debating about his economic philosophy. Just recently, the European Union is considering a new round of economic stimulus to help grow the economy and reduce unemployment. Some Keynesian thinkers opine that the fiscal stimulus applied by the U.S. government was too timid to be effective. The other side of the debate claims it did not work as promised exactly because it was Keynesian. We wonder if this debate will ever be fully resolved.

On the other hand, we think the world would be a much better place if all investors warmly embraced the investment approach of Mr. Keynes (the successful value one, not the lose-all-your-money speculating one…). Regardless of ones' exact approach to investing, we think that having a well-defined, disciplined method of investing will always yield better results than a random, wishful one.

The Outlook

We again note that it has been a long time since we have seen a 10% correction in the stock market. In a normal bull market, 10% corrections are natural and normal. We experienced larger-than-normal corrections in 2010 and 2011, and none in 2012 or 2013. This is not unprecedented, just a bit on the unusual side. Thus, a correction of up to 10% would not be surprising, in our view. We have no particular insight as to why or when this may happen; we just want again to highlight this possibility.

At the risk of sounding like a broken record, we continue to think that we are in an equity bull market. Bear markets tends to happen just before a recession. Recession tend to happen after a period of very strong economic growth that might lead to damaging inflation. Tight money policy tends to precede a recession. We see none of these factors in the near future. Corporate earnings continue to grow, cash is still piling up on corporate balance sheets and companies still seem to be conservative in capital spending and hiring. Housing has improved and this will likely help consumer spending. Most economic forecasts expect global GDP to be stronger in 2014 than it was in 2013. The U.S. Federal Reserve is unlikely to tighten monetary policy before the U.S. economy is on a steady, self-sustaining track. The record number of initial public offerings (highest since 2007), in our view, is a yellow flag for the stock market, in the near term, but ultimately, companies with good fundamentals will prosper and those rushed to the market simply to capitalize on the window of opportunity will reap their customary reward.

We still think that cash (beyond some reasonable "rainy day" reserve) is the worst asset for investors to hold. We continue to think that the longer-term trend for interest rates may be higher, but a simple "sell bonds and buy stocks" cannot apply to all investors. Patches of economic weakness, uncertainty due to military (or political) conflict and market shocks are all good reasons for investors whose long-term asset allocation is not 100% stocks to hold bonds.

Sincerely,

Wolf Group Capital Advisors

Becce, do we need to put this - Wasik, John. Keynes's Way to Wealth. New York: McGraw Hill, 2014.Print. Somewhere?