



Portfolio Manager Commentary

FEEDBACK INVESTORS AND ELECTRIC SHOCKS

**MOATX
CASTX**

January 7, 2014

FOURTH QUARTER LETTER

MARKET COMMENTS

“As I think back over the years, I have been guided by four principles for decision making. First, the only certainty is that there is no certainty. Second, every decision, as a consequence, is a matter of weighing probabilities. Third, despite uncertainty we must decide, and we must act. And lastly, we need to judge decisions not only on the results, but on how they were made. Most people are in denial about uncertainty. They assume they’re lucky, and that the unpredictable can be reliably forecast. This keeps business brisk for palm readers, psychics, and stockbrokers, but it’s a terrible way to deal with uncertainty. If there are no absolutes, then all decisions become matters of judging the probability of different outcomes, and the costs and benefits of each. Then, on that basis, you can make a good decision.”

—Robert Rubin, Former Secretary Of The Treasury

On the Friday before Thanksgiving, in reaction to a few comments made by European Central Bank President Mario Draghi, the euro plunged and just about every other liquid asset class in the world rallied: U.S. stocks were up, European stocks were up, emerging market stocks were up, gold and precious metals were up, oil was up, U.S. Treasuries were up, and last but not least, even the Japanese Yen was up! This broad, uniform market action is abnormal, as these wide-ranging asset classes typically move in different directions in reaction to macroeconomic signals.

“We will do what we must to raise inflation and inflation expectations as fast as possible, as our price-stability mandate requires,” Mario Draghi said on that particular Friday. Shorter-term inflation expectations “have been declining to levels that I would



deem excessively low,” he also said. He went on: “There is a combination of policies that will work to bring growth and inflation back on a sound path. If on its current trajectory our policy is not effective enough to achieve this, or further risks to the inflation outlook materialize, we would step up the pressure and broaden even more the channels through which we intervene, by altering accordingly the size, pace and composition of our purchases.”

It is now official - Draghi confirmed that central bankers have lost their minds. The head of the Bank of Japan is deliberately destroying the yen and the head of the European Central Bank is frantically seeking a politically-acceptable way to destroy the euro. By comparison, the U.S. Federal Reserve looks shockingly prudent despite unprecedented stimulus via Quantitative Easing.

When faced with a weakening economy, modern central bankers now resort to creating more money in a misplaced effort to raise prices, as if a higher cost of living is what the average wage earner really needs at a time when the economy is struggling. Central bankers seemingly believe that actions designed to depreciate money, distorting the price signals upon which investment decisions are based, are in the best interests of the broad economy. They are wrong.

When those institutions closest to the Federal Reserve can borrow billions of dollars for almost nothing, cash earned by individuals from labor and saved over years is reduced to a quaint habit of past generations. As a result, no saver can rationally bid for a house, or any other asset, against a Wall Street financier who can borrow essentially unlimited cash. The individual can sometimes leverage their cash 4-to-1 when purchasing a house: a 20% down payment with a mortgage of 80% borrowed money. By contrast, the financier can borrow as much as they want for almost nothing. Due to the excess liquidity created by the U.S. Federal Reserve, and almost every other central bank around the world, the individual saver will lose when bidding for assets. Central banks justify this enormous expansion of credit by arguing that investors and businesses will put that nearly-free money to work. However, the problem with cheap credit is that it does not flow to productive investments—cheap credit flows to safe yields. Launching a new product, service, or business is risky. Wall Street financiers know that the safe way to play unlimited credit is to purchase assets that generate reliable returns.

Assume my mother-in-law wants to buy a house as an investment for rental income. She will make a 20% down payment in cash and then pay 4% for the 80% of the money borrowed through a mortgage. The rental income must exceed her costs by at least 3% - which include the mortgage, property taxes, and maintenance. Otherwise, she might as well buy a long-term Treasury bond and earn the 3% without incurring the risk of vacancies and unexpected expenses such as a new roof or water heater. Since her mortgage costs 4%, the house’s investment yield must be considerably higher to justify buying the house. After paying the mortgage, property taxes and maintenance, one should assume that the rental income must generate a gross return of 10% in order to yield a 3% return net of all expenses.

Now consider the private equity financier who pays less than 1% for their borrowed money and invests with an entirely different calculus. Since the cost of their borrowed money is so cheap, the private equity financier can raise their bid by 25% and the additional interest expense remains inconsequential, simply because buying low-yield assets is still profitable if one can borrow money for almost nothing.

This scenario repeatedly plays out across the economy and results in excess liquidity, in the form of cheap credit, creating bubbles in every asset class that yields a low-risk return. Inevitably, excess liquidity collapses simply because all extremes eventually revert to the mean, as asset prices reach heights that even free money can no longer sustain in terms of valuation. At that moment, speculators lose confidence in the central bank policies that have issued cheap credit as the cure for all economic ills.



In the spring of 1976, when investors were still recovering from the severe bear market of 1973 and 1974, Donaldson, Lufkin & Jenrette, an investment bank, hosted a conference that matched two investing legends onstage at the same time — Benjamin Graham and Charles Ellis¹. Ellis asked Graham why the 1970s were such a disaster in the stock market for most investors. Graham replied that, “*most investment professionals, although possessing above average intelligence, lacked an overall understanding of common stocks.*” After the seminar, Graham and Ellis continued their conversation. Graham stated that “*the problem with our industry is not speculation per se; speculation has always been a part of the market and always will be. Our failure as professionals is our continuing inability to distinguish between investment and speculation. If professionals can’t make that distinction, how can individual investors? The greatest danger that investors face is acquiring speculative habits without realizing they have done so [emphasis added]. Then they will end up with a speculator’s return — not a wise move for someone’s life savings.*”

Most investors correctly understand that speculation occurs when one determines an investment based on price rather than by its fundamental value. However, as Benjamin Graham states, speculation occurs when one begins making decisions outside of a well-defined process, if any process exists at all. If an investor has no plan, they are speculating. A systematic process is how the investor imposes discipline when investing in a market of unknown variables. Without a consistent investment process, the investor acquires speculative habits without realizing they are now competing against an impossible benchmark — short-term market price fluctuations. As Robert Rubin said, “*we need to judge decisions not only on the results, but on how they were made.*” While everyone enjoys the success of short-term speculative returns, it is the discipline of the investment process that prevents the investor from crossing over to speculation.

Understanding the discipline of an investment process brings to mind the parable about the old man who owned an apple tree². The tree was healthy and, with modest care, yielded a crop of apples which the old man could sell for about \$100 each year. One day the man decided to sell his apple tree. He placed an ad in the paper that simply stated: “For sale, apple tree—best offer.”

An investor answered the ad and offered \$50 to buy the tree—the amount the tree would fetch if cut down and sold for firewood. The old man declined knowing that his tree was worth far more than its salvage value. A second investor appeared and offered \$100—the amount this year’s crop of apples would make at the market. The old man declined, knowing that the tree would produce apples again next year and many years into the future. A third investor quickly offered \$1499 figuring that the tree would live another fifteen years and calculated 15 years multiplied by \$100 in apples on average sold per year. The offer intrigued the old man but he knew it would be unfair to take the offer—\$100 earned by selling apples fifteen years from today is not worth the same as selling \$100 in apples today. The old man knew that if you placed \$41.73 in a bank account today paying 6% interest, you would have \$100 at the end of fifteen years. Therefore, the present value of \$100 worth of apples fifteen years from now, assuming an interest rate of 6%, is only \$41.73—not \$100.

A fourth investor finally appeared and spoke with the old man. Although the apples sold for \$100 last year, the investor told the old man that this was not his profits from the tree—there were expenses associated with the \$100 in revenue. There was the cost of the fertilizer, tools, labor, transportation to the market, and finally taxes. The intelligent investor knew that the revenue from selling the apples was \$100 but the cash profits were only \$50. Additionally, some years the tree produced more apples and other years it produced fewer apples. However, the more difficult task in valuing the apple tree is determining how to value an asset that produces approximately \$50 in cash every year into the future. If the apple tree’s cash profits were steady and predictable,

¹ Robert Hagstrom, *Latticework: The New Investing* (Texere, 1st edition, November, 2000)

² “The Old Man and the Tree: A Parable of Valuation” Solomon, Schwartz & Bauman – *Cases and Materials* at 143, 3rd edition, 1996

CASTLE FOCUS FUND



PM Commentary :: Q4 2014

Investor Class: MOATX Class C: CASTX

like a U.S. Treasury bond, it would be easy. Unfortunately, future profits are not guaranteed. The intelligent investor must take into account risk and uncertainty. Apples could glut on the market one day and one would have to cut the price in order to sell their apples. A drought could reduce the number of apples produced one year, or the tree could become diseased and die. If the risk of ruin is deemed high, an investor should demand that a single year's profit represent a higher percentage of the value assigned to the tree.

In order to balance risk and uncertainty against future expected returns, the investor and the old man agreed to conservatively project future cash profits. They estimated \$50 in annual cash profits for the next five years, followed by \$40 in annual cash profits through year fifteen, the expected remaining life of the apple tree, at which point the tree could be sold for firewood at \$50. They now had to discount these future projected cash flows and needed to determine a discount rate.

Once upon a time (in the year 2000, for instance) a conservative investor placed money in a bank and received 5% interest, insured. A few years earlier, an investor could have purchased debt obligations of the U.S. government and received 7% interest, essentially risk free, or the theoretical rate of return of an investment with no risk of financial loss. Today, if one is willing to lock up their money in a one-year Treasury bill, they can earn approximately 0.11%. At this rate, if one locked up \$100,000 for one year, they would earn only \$110. A U.S. government debt obligation maturing in ten years currently yields 2.25%, the market's current risk free rate. Anywhere else that one places their money deprives them of the opportunity to earn 2.25% risk free. Therefore, if the intelligent investor discounts the old man's future projected cash flows by 2.25%, he will only receive compensation for the time value of the money invested in the tree rather than in U.S. government securities.

Old Man's Apple Tree Projected Cash Profits

Year	Cash Flow
1	\$ 50
2	\$ 50
3	\$ 50
4	\$ 50
5	\$ 50
6	\$ 40
7	\$ 40
8	\$ 40
9	\$ 40
10	\$ 40
11	\$ 40
12	\$ 40
13	\$ 40
14	\$ 40
15	\$ 40
Salvage Value	\$ 50

Year	Cash Flow	6.25%	10.00%	3.00%
1	\$ 50	\$ 47.06	\$ 45.45	\$ 48.54
2	\$ 50	\$ 44.29	\$ 41.32	\$ 47.13
3	\$ 50	\$ 41.69	\$ 37.57	\$ 45.76
4	\$ 50	\$ 39.23	\$ 34.15	\$ 44.42
5	\$ 50	\$ 36.93	\$ 31.05	\$ 43.13
6	\$ 40	\$ 27.80	\$ 22.58	\$ 33.50
7	\$ 40	\$ 26.17	\$ 20.53	\$ 32.52
8	\$ 40	\$ 24.63	\$ 18.66	\$ 31.58
9	\$ 40	\$ 23.18	\$ 16.96	\$ 30.66
10	\$ 40	\$ 21.82	\$ 15.42	\$ 29.76
11	\$ 40	\$ 20.53	\$ 14.02	\$ 28.90
12	\$ 40	\$ 19.32	\$ 12.75	\$ 28.06
13	\$ 40	\$ 18.19	\$ 11.59	\$ 27.24
14	\$ 40	\$ 17.12	\$ 10.53	\$ 26.44
15	\$ 40	\$ 16.11	\$ 9.58	\$ 25.67
Salvage Value	\$ 50	\$ 20.14	\$ 11.97	\$ 32.09
		\$ 444.20	\$ 354.12	\$ 555.41

When the investor considers that the cash profits from the apple tree are not riskless, he must use a higher discount rate to compensate for the added risk. Meaning, the investor must add a risk premium to the risk free rate. By definition, the risk premium is the minimum amount of money by which the expected return on a risky asset must exceed the known return on a risk-free asset in order to induce an individual to hold the risky asset rather than the risk-free asset. Since 1954, or the past sixty years, the average constant maturity yield on the ten-year debt obligation of the U.S. government averaged 6%--the long-term average risk-free rate. Aswath Damodaran³, Professor of Finance at the Stern School of Business at NYU, estimates that the long-term equity market risk premium averages 4%. Together, the historical risk-free rate and the equity risk premium equal 10%, the rate we believe appropriate when

³ <http://aswathdamodaran.blogspot.com/2013/05/equity-risk-premiums-erp-and-stocks.html>



discounting future cash flows of publicly-traded companies to the present value. However, today's risk-free rate of 2.25% plus a 4% equity risk premium only equals a discount rate of 6.25%.

Therein lies the dilemma for today's value investor—does a historically low discount rate properly account for all future risks, known and unknown, when valuing an asset's projected cash flows? Is 6.25% the appropriate discount rate or are we acquiring speculative habits without realizing it? If the investor discounts the apple tree's future cash flows at 10%, he will calculate fair value at \$354. By contrast, the investor comfortable discounting the apple tree's projected future cash flows for the next fifteen years at 6.25% will justify \$444 as fair value—a price 25% higher than the investor using 10% as their discount rate. And, should our private equity financier with access to unlimited cheap capital enter the bidding process, they might justify a 3% discount rate and find \$555 to be fair value for the apple tree.

As the stock market grows increasingly comfortable discounting future cash flows at lower and lower rates, we sense that Benjamin Graham's advice to *distinguish between investment and speculation* is once again falling on deaf ears as investors seek reasons to justify higher prices.

INVESTMENT PHILOSOPHY

"Risk comes from not knowing what you're doing."

--WARREN BUFFETT

As many investors will acknowledge, the emotions of greed and fear move markets. Investors can often grow too bullish just as they can occasionally become too bearish. The intelligent investor takes advantage of the irrational behavior, ready to act when the collective misprices an asset such as a stock.

Just as a single stock is sometimes mispriced, so too is the entire stock market. Rather than follow a disciplined investment process, investors react to news and opinions and are greatly influenced by recent events. They become "feedback investors"—as stocks move higher and higher, more and more people enter the market hoping for quick and easy profits. These feedback investors either do not know or do not care what the real value of the shares they buy or the index funds they own. They see the stock market rise, and they grow convinced that it is going still higher and feel compelled to act.

A recent study in the journal *Science* confirms that many people would rather get an electric shock than just sit and think⁴. Psychologists at the University of Virginia⁵ asked college students to sit for fifteen minutes in a plain room doing nothing but thinking. The researchers asked the students to record how well they concentrated and how much they enjoyed this activity. Most of the students reported that they could not concentrate, and in fact half the students actively disliked the experience.

Thinking it was perhaps something related to the sterile lab room, researchers had the students sit and think in their own homes. They disliked the experience even more. In fact, 32% of the students reported that they cheated by looking at their email on their cellphone or sending a quick text message. The researchers also conducted the experiment with a middle-aged church group, and the results were the same. Age, gender, personality, social-media use—nothing made much difference. At that point, the

⁴ Timothy Wilson, David Reinhard, et al, "Just think: The challenges of the disengaged mind", *Science* July 2014: Vol. 345 no. 6192 pp. 75-77

⁵ <http://www.wjh.harvard.edu/~dtg/WILSON%20ET%20AL%202014.pdf>



researchers then administered the students a mild electric shock and asked if they would pay to avoid another shock. The students sensibly said that they would pay in order to avoid another shock. Subsequently, the researchers then put each student back in the room with nothing to do - but this time they provided the student with the shock button. Amazingly, many of the students voluntarily shocked themselves rather than face the discomfort of doing nothing. Perhaps not so surprising, there was a noticeable difference between the sexes. Sixty-seven percent of the men preferred a shock as opposed to doing nothing—only 25% of the women preferred to self-administer a shock.

Neuroscientists discovered that boredom was associated with a distinctive pattern of brain activity. Strangely enough, when we do nothing, many parts of the brain that underpin complex thinking activate. Although we take daydreaming for granted, it is actually a powerful form of thinking. Evidently, doing nothing is also difficult.

If neuroscience suggests that just thinking can be very valuable, then why is it so hard? One could easily blame the modern world, but ten centuries ago, Buddhist monks had the same problem. Meditation carries proven benefits, but it takes discipline, practice and effort. By contrast, our human impulse is to be up and doing. When one considers the amount of information available to investors today, one realizes how difficult it can be for an investor to remain patient, think and act only very infrequently. Computing power now allows investors to sift through thousands of pieces of data, look at historical trends, patterns and performance statistics, while simultaneously back-testing any number of strategies. If current trends hold, technology will continue its hold on investors, but technology will not change human nature. In a lecture to his students during a value investing class in the late-1940s, Benjamin Graham discussed this problem⁶:

“In one important respect we have made practically no progress at all, and that is in human nature. Regardless of all the apparatus and all the improvements in techniques, people still want to make money very fast. They still want to be on the right side of the market. And what is most important and most dangerous, we all want to get more out of Wall Street than we deserve for the work we put in.”

As technology continues to dominate the investment management process, temperament will only become more important for investors. There are plenty of intelligent participants in the financial markets, but not nearly enough that focus on patience, thinking and their emotional discipline—traits all necessary for a long-term investor to succeed among a market dominated by speculation. As Warren Buffett once said, *“Risk comes from not knowing what you’re doing.”* Having a systematic process mitigates risk to a large degree but it does not prevent the risk of short-term losses or underperformance; however, it does prevent the investor from speculating with their life’s savings.

With kind regards,

Robert J. Mark
Portfolio Manager

⁶“The Rediscovered Benjamin Graham Lectures” Lecture Number Ten, John Wiley & Sons, 1999



CASTLE FOCUS FUND



PM Commentary :: Q4 2014

Investor Class: MOATX Class C: CASTX

The opinions expressed are those of the Fund's portfolio manager and are not a recommendation for the purchase or sale of any security.

The Fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The prospectus contains this and other important information about the Fund, and it may be obtained by calling 1-877-743-7820, or visiting www.castleim.com. Read it carefully before investing.

Performance data quoted represents past performance; past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of the fund may be lower or higher than the performance quoted. Performance data current to the most recent month end may be obtained by calling 1-877-743-7820.

The risks associated with the Fund, detailed in the Prospectus, include the risks of investing in small and medium sized companies and foreign securities which may result in additional risks such as the possibility of greater price volatility and reduced liquidity, different financial and accounting standards, fluctuations in currency exchange rates, and political, diplomatic and economic conditions as well as regulatory requirements in foreign countries. There also may be risks associated with the Fund's investments in exchange traded funds, real estate investment trusts ("REITs"), significant investment in a specific sector, and nondiversification. Technology companies held in the Fund are subject to rapid industry changes and the risk of obsolescence. The Fund is non-diversified, meaning it may concentrate its assets in fewer individual holdings than a diversified fund. Therefore, the Fund is more exposed to individual stock volatility than a diversified fund.

Distributed by Rafferty Capital Markets, LLC-Garden City, NY 11530, Member FINRA.