Prudent-Growth since 1995 RAM Capital Management llc

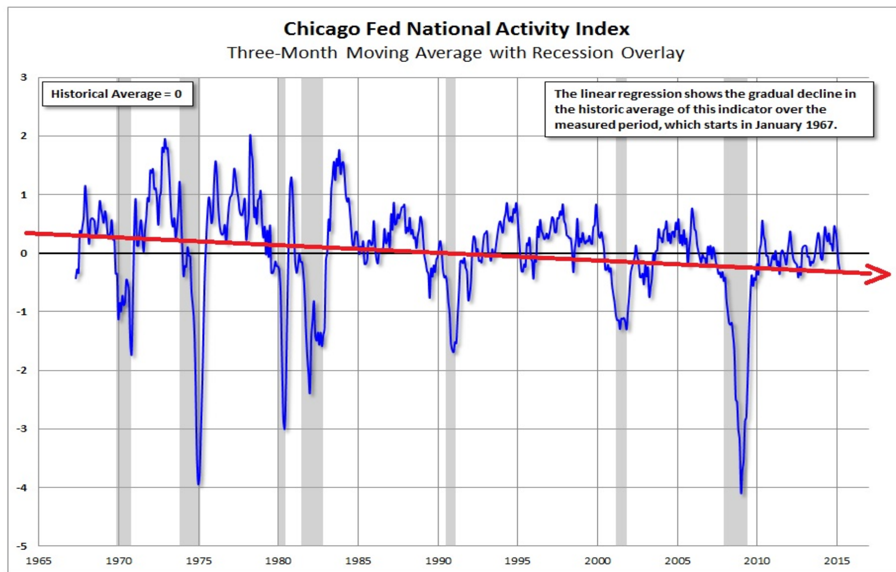
*Commentary for April 2015** *April 16, 2015* *From: Robert Munsie*

Recall RAM Capital Management's disciplined investment-process is two pronged. First, identify great companies demonstrating >15% returns to shareholders over the long term for investment when their stock prices are attractive. This requires a bottom-up analysis effort but will not be covered in this piece.

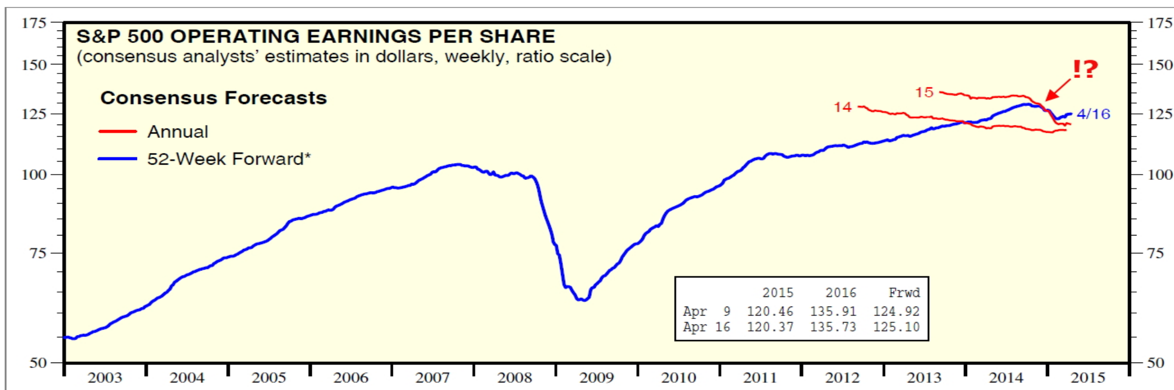
This commentary discusses aspects that factor into the second discipline of our investment process that impacts our portfolio's risk positioning and encompass Corporate Fundamentals and Market Environment.

1. Corporate Fundamentals:

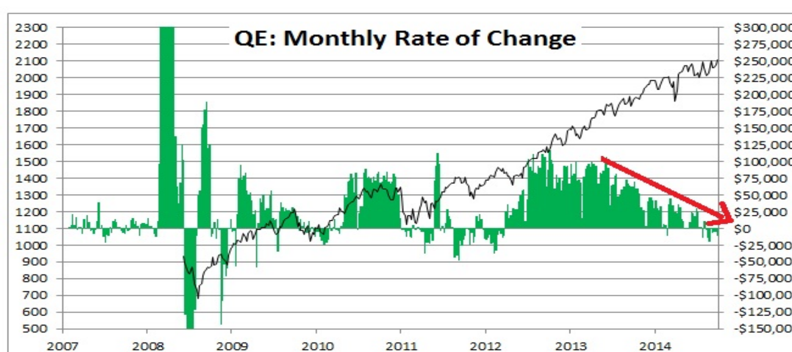
While showing perennial growth for decades the US economy has been experiencing a secular decline in domestic growth (see chart below) possibly due to unfavorable demographic trends. Fortunately this has been more than offset by US companies' expansion in international markets. That said, the combination of the end of QE, which has provided the impetus for the current recovery, and the spike in the US dollar, which will lessen international profitability, could leave corporate fundamentals at risk in 2015 and 2016.



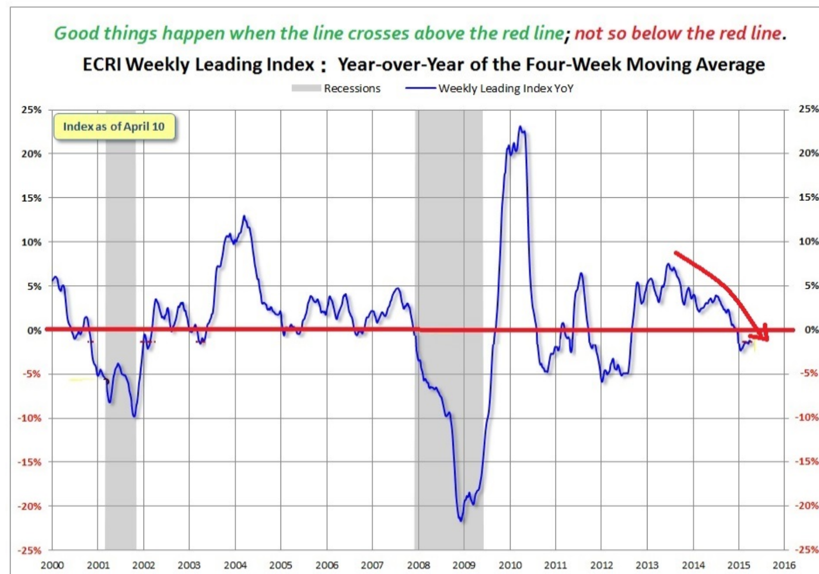
While the market's earnings (the blue line in below chart) has more than recovered from the 2008/2009 financial crisis low and are now above the level attained in 2007, companies are now struggling to meet analyst's initial forecasted earnings (see 2014 and 2015 red lines). Clearly, while companies are reporting a beat of earnings, they are earnings that have been reduced during the previous two years.



We believe this is due to the deteriorating post-crisis global recovery rate. For the 2015 forecast that deterioration is accelerating. While it is clearly a function of the collapse of oil prices reducing oil company profits is not being positively felt by those companies and consumers for whom it should be a benefit. We believe it could be due to the gradual reduction in QE by the Fed starting in mid-2013 (see below chart) which is spilling over to the general economy.

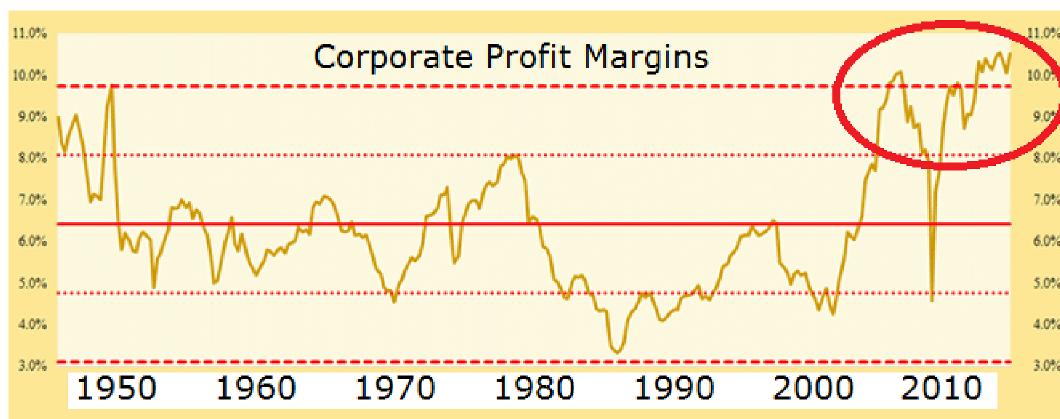


Not surprisingly, given the decline of QE starting in mid-2013 in the above chart, the chart below shows a comparable decline in the ECRI leading activity rate also starting in mid-2013. Given the price of oil only accelerated in late 2014 we believe its decline was a symptom of economic activity reduction rather than the other way around. If it were simply the increase in fracking-oil supply it would have quickly recovered to $100+ per bbl with the decline in rig activity.



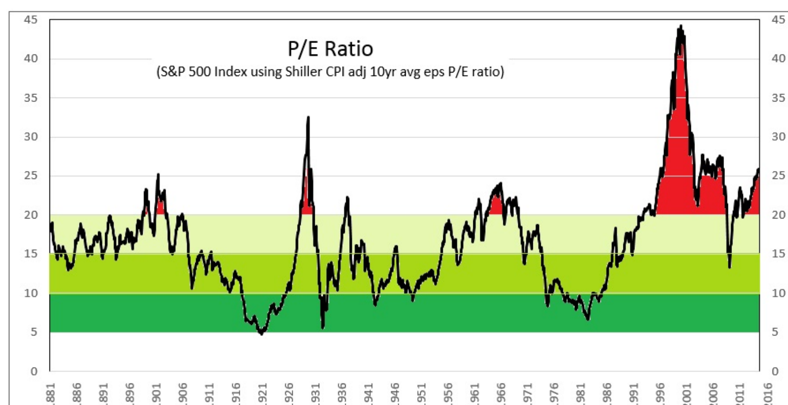
With QE growth behind us and interest rates already at zero, the negative leading index could indicate a prolonged period of flat, or declining, corporate earnings. It should be noted that each decline below zero of the ECRI index coincided with a severe stock-market correction which has yet to be seen this time.

Why are we concerned about this inability to beat original earnings? If the stock market depended on revenue growth it would be a severe bear market. The driver of corporate earnings has not be top line growth but profit margins. As this chart shows since WWII profit margins have averaged around 6%. Only in the past decade have they moved two standard deviations from this norm.



If this was due to operating leverage it would be understandable but it has not. In fact asset-turns have been declining. Furthermore it has not be due to cost-of-goods declines as gross margins have also been declining. The profit-margin gains are coming from below the gross operating margin line. Staff and wage cuts (reducing SG&A expenses), capital investment postponement (reducing depreciation expenses), declining interest rates (reducing interest expenses), and tax avoidance strategies (reducing income-tax expenses) have taken the profit margin to a high of 10%. It is hard to believe US corporations are not approaching a tipping point to the downside for profit margins. Wages are now headline news and entities are starting to adjust accordingly (Walmart & California). But the internet momentum as a price disrupter continues and companies should not expect to pass these cost increases on to their customers. This has the potential to move profit margins back to its mean of 6%.

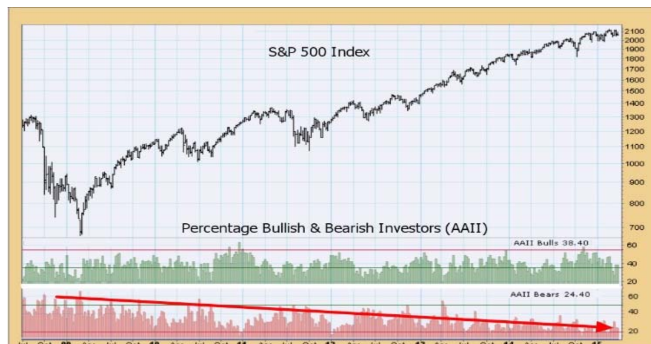
This decline in profit margins would be catastrophic for the stock market especially for those companies lacking in a "moat-like" defense of their business model.



2. Stock Market Environment:

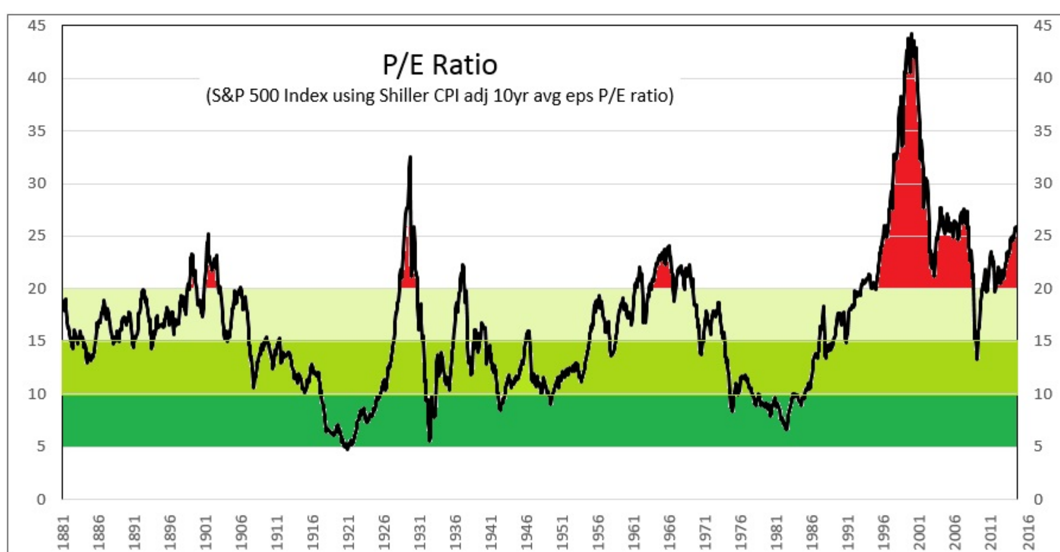
While the annual returns of the US stock market over the last 15 years have been well below the norm, the huge rally out of the financial crisis low has, in some respects, created a sense of complacent bullishness towards stocks. That sad, there still remains a core of investors who remain on the sidelines and may represent future buyers to propel the stock market higher in the future.

Individual investors, who were universally bearish at the market lows during the financial crisis (see red arrow in below chart), have all but disappeared. If they now become bullish during the next market rally this may prove to be the tipping point for the market and mark the start of the first significant correction in years.



This decline in bearish attitude has manifested itself in how investments have been allocated by investors between bullish and bearish funds. The chart below shows that assets in bullish funds have now far outstripped assets in bearish funds. The risk is if markets start to decline bull fund liquidations will find no new buyers except at much lower prices.

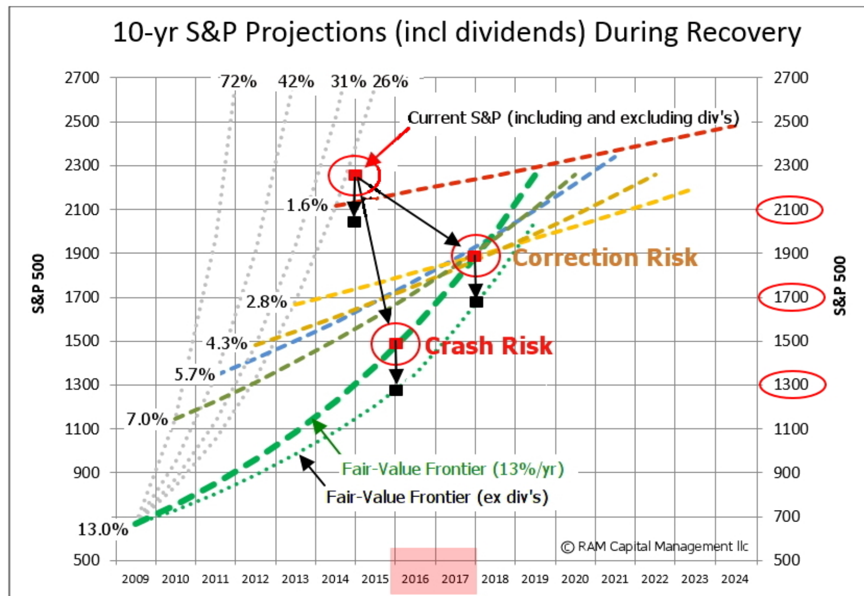
This decline in bearishness has emerged in spite of the increased risk of overvaluation for stocks. The Shiller yardstick below, as good as any, is indicating stock valuations at levels seen only during periods of extreme overvaluation. Only an outsized increase in earnings or a significant decline in stock prices would return this measure back to historical levels. Assuming lower profits from increase wages etc. translate to lower earnings per share the risk of a 'double whammy' to stock prices, due to a price-earnings ratio residing at unprecedented levels, becomes real.



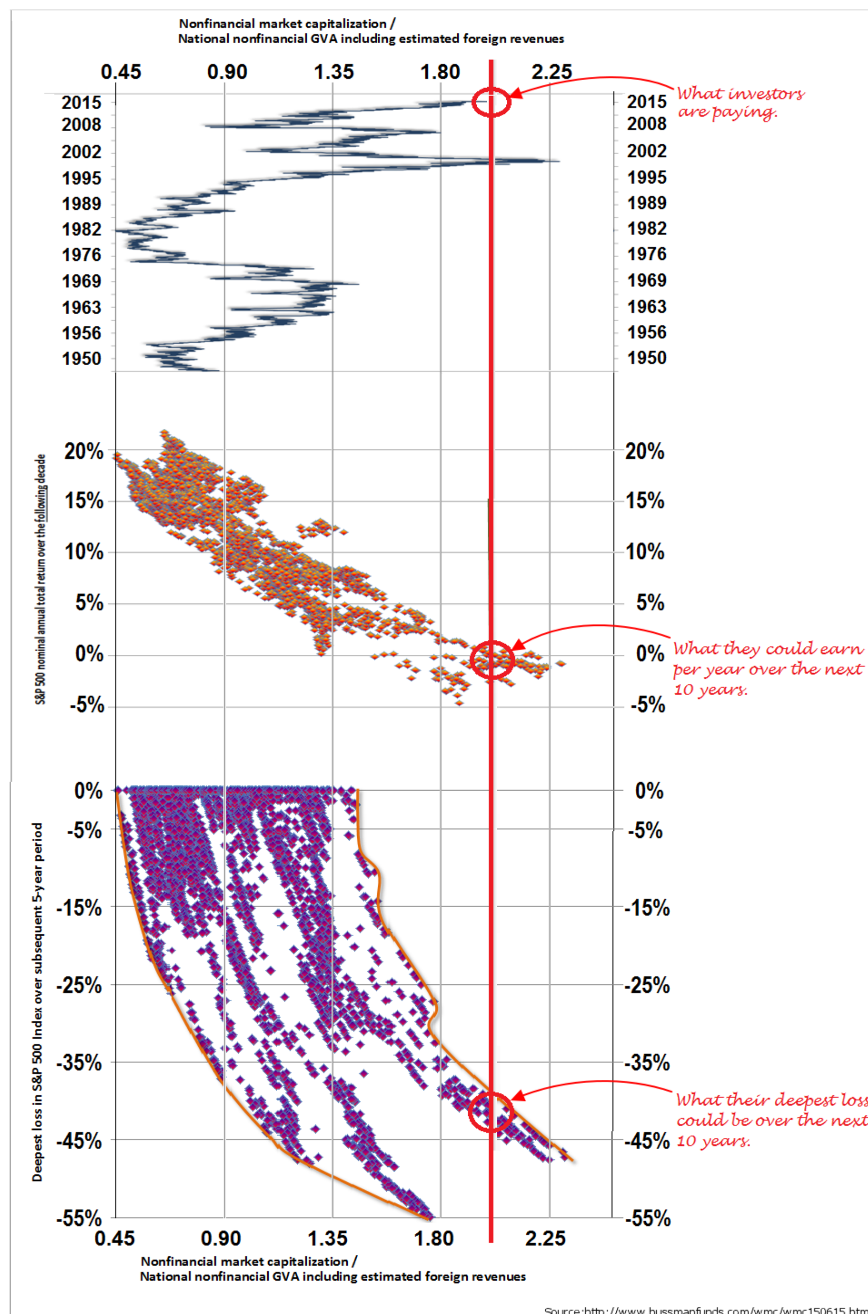
Portfolio Allocation Conclusion:

We believe RAM's great companies continue to execute but we believe the risk of valuation pricing risk is greater to the downside.

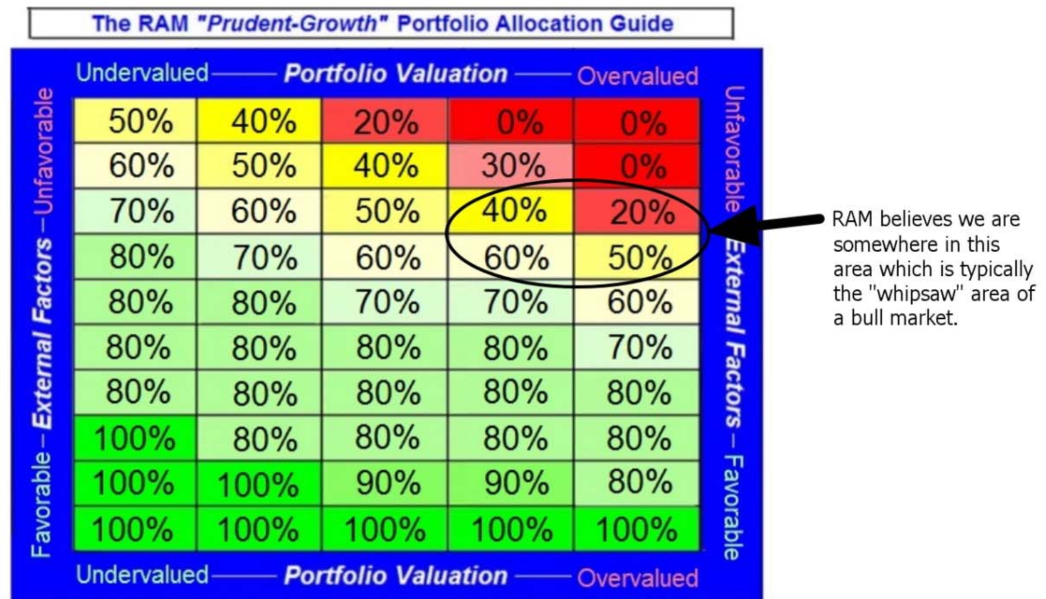
As a result of the negative issues described above and the market's significant recovery since the crisis lows the return potential has diminished meaningfully. The below chart is a guide that depicts how price movements and valuations have impacted potential returns for US stocks. This one yardstick is indicating, even with dividends included, the long term potential for stocks does not warrant the risk. No return for 10 years, and 20% to 40% on the downside.



The combination of the 3 charts below again shows the history of *no-gain/all-pain* for stock investor's long term when stocks trade at these levels.



Given the above discussion our analysis leads us to a stock allocation in the range circled in the table below. As always this data will be continuously analyzed and allocations will be adjusted accordingly using this chart as a disciplined guideline.



The RAM "*Prudent-Growth*" Portfolio Allocation Guide

Undervalued — Portfolio Valuation — Overvalued				
50%	40%	20%	0%	0%
60%	50%	40%	30%	0%
70%	60%	50%	40%	20%
80%	70%	60%	60%	50%
80%	80%	70%	70%	60%
80%	80%	80%	80%	70%
80%	80%	80%	80%	80%
100%	80%	80%	80%	80%
100%	100%	90%	90%	80%
100%	100%	100%	100%	100%

As is our style we will take the market evidence as it comes and adjust our investment risk and stocks held accordingly.

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* DISCLOSURE

Past performance is not indicative of future results.

A Single Managed Account (SMA) is an actively managed portfolio. There is no guarantee that any investment will achieve its objectives, generate positive returns, or avoid losses. The SMA will incur a loss as a result of a short position if the price of the short position instrument increases in value between the date of the short position sale and the date on which the SMA purchases an offsetting position. The SMA's losses are potentially unlimited in a short position transaction. A higher portfolio turnover will result in higher brokerage transactional costs.

Investors should carefully consider the investment objectives, risks, charges and expenses of an SMA account offered by RAM Capital Management LLC. Any performance data quoted here represents past performance. Current and future performance may be lower or higher than that experienced in the past. Investment return and principal value will fluctuate, so that SMA accounts, when closed, may be worth more or less than their original cost. Past performance is no guarantee of future results.

The performance shown in all charts and tables for RAM's Prudent Growth Portfolio is for a single-managed account (SMA) managed on a fully-discretionary basis by RAM Capital Management LLC (RCM) and that adheres fully to RCM's Prudent-Growth investment process and portfolio execution. In some cases, due to the modest size of an account or if client restrictions are placed on the account, the SMA account's performance may vary.

The past performance for January 1, 1996 to September 30, 2010 is for the RAM Capital L.P fund. The prior performance is net of transaction expenses and net of management fees. Also prior performance does not include the effect of the LP's performance fee, which does not apply to SMA accounts. On October 1, 2010 the partnership was converted to, and its performance was ported to, the RAM Risk-Managed Growth Fund, a mutual fund adhering to the Investment Companies Act of 1940 and regulated by the SEC. Performance as a mutual fund was net of management fees (1%) and expenses (0.25%), terms incorporated in the fund's Class I prospectus. Since the fund's inception on January 1, 1996 the LP and the mutual-fund investment vehicles were managed in the same style, the Prudent-Growth style, by the same portfolio manager, Mr. Robert Munsie, and by the same advisor, RAM Capital Management LLC. Effective September 30, 2011 all past net performance for the Prudent-Growth portfolio was adjusted for the SMA management-fee rate of 1.00%. Since October 1, 2011 performance is based on a representative taxable SMA account net of the 1.00% management fee. Typically charts and tables depicting performance for less than one year are gross of management fees. **The past performance is not necessarily an indication of how an SMA will perform in the future.**

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