

CEERA INVESTMENTS, LLC

LETTER TO CLIENTS: 2012 YEAR-END REVIEW

February 2013

The financial markets, worldwide, have had a nice run the last several months. 2012 was an above average year for the US equity markets--the broad market index, the S&P500 Index was up almost +16% (including dividends), whereas the Dow Jones Industrial Average (DJIA) was up about +10%. Furthermore, 2013 got off to one of the best starts in years. The MSCI EAFE Index that tracks developed equity markets in Europe and the Pacific regions was up +17.3% in 2012, whereas the MSCI Emerging Markets Index that tracks investment return of stocks issued by companies located in emerging market countries was up +18.2%. The domestic investment grade bond market, as represented by the Barclays Aggregate Bond Index was up +4.2% last year.

STATE OF THE US EQUITY MARKETS

While we prefer the world of intrinsic values of businesses and inefficient market prices, keeping an eye open on the broader markets has never hurt and so here's a brief look at the state of the US equity markets-- an area where most of our capital appreciation opportunities have historically been generated. During October '08 to March '09, market volatility was at record levels, sentiment was downright depressing, unemployment trends were not encouraging, and the future appeared bleak to many. We now stand at the beginning of 2013 when the "pendulum" appears to have swung towards the other end: the US equity markets are back to the high levels seen last in 2007, employment levels have improved, and the outlook is not that bleak anymore—a good time to review the current equity market environment.

To do so, I would like to highlight a variation of an indicator that has often been quoted by Warren Buffett--let me call it the "Modified WB Ratio". This is a ratio of the Total Domestic (US) Equity Market Capitalization to the US Gross National Product (GNP) (Average of previous four quarters being the variation used here), and over time this ratio has proved to be a good indicator of the extremes in the equity markets—a very high value indicating overvaluation in the domestic equity markets and vice versa.

As the graph below indicates, since 1995, the Modified WB Ratio has typically bottomed out at around 100%, except in March 2009 when it did so around 70% and coinciding with the market bottom after the financial crisis. On the upside, this ratio has seen levels in excess of 180% (during the internet bubble days) and hasn't stayed above the 140% levels for very long periods of time (except again during the internet bubble days). The median value during the period since 1995 has been about 130% and the current level of this ratio is about 132%.

GRAPH 1: THE MODIFIED WB RATIO



Sources: www.world-exchanges.org, www.bea.gov

So, what does this graph tell us? At the very least, it would be safe to say that being currently close to the median, the Modified WB Ratio is pointing to fair valuations in the domestic equity markets, from a macro perspective. At the same time the current level of 132% is very close to the top end of a typical range for this ratio, if one adjusts for the days of the internet bubble as outliers. Various other indicators that we look at are either indicating a neutral valuation bias or a fair to excess valuation bias in the US equity market environment. All in all, in our view a time to dig harder and deeper to find undervalued investments.

2012: A YEAR IN REVIEW

Before jumping into the review, I would like to point out that the degree to which the following discussion pertains to each client is a function of the unique characteristics of each client's profile--a client's **personal portfolio objectives** (several clients have income generation objectives and fixed income instruments as holdings), **inception dates** (and therefore likelihood of ownership of some or all of the investments mentioned, levels of un-invested cash levels, and related performance), **client-specific needs and restrictions**, and so on. However, given most clients have Long-Term Capital Appreciation as their sole objective or as one of the objectives in their portfolios, this review will attempt to summarize developments in such a typical portfolio (which tends to be equity heavy) via positions in the Ceera Capital Appreciation Model Portfolio¹, which is a virtual portfolio that mirrors the investments of our typical Capital Appreciation client.

Typically, as most of you are likely aware, we make Capital Appreciation investments that are **individual securities** such as stocks or bonds in two categories:

¹ For more details/disclosures on the Model please visit: <http://www.ceera.com/pdf/modelportfoliodisclosures.pdf>

- 1) Short/Medium Term Holdings (or “**Special Situations**”): Businesses/situations that are temporarily undervalued and display attractive return characteristics versus inherent downside risks. We prefer to move out of such investments once we see that the market has recognized the fair value of such a business/situation and in the process we have realized an appropriate rate of return, i.e. we do not hold this type of investment longer than is necessary.
- 2) Long-Term Holdings (or “**Generals**”): Businesses characterized by good /great competitive advantage, returns on capital, management, and growth prospects. We try to pick this type of investments when they get undervalued temporarily in our assessment. We prefer to buy and hold such businesses for a REALLY long time and piggyback on the growth of such enterprises, hopefully for years to come. We would sell the “Generals” only under certain circumstances—a deteriorating business/ model, management issues, severe overvaluation, need for capital for a relatively better investment, and so on.

The overall profile of a typical portfolio at a given point in time is thus a function of the relative opportunities in the above two types of investments that we have been able to invest your capital in. Ideally, we would love to fill a portfolio with 15 or so wonderful businesses in the “Generals” category and let these businesses appreciate our capital for us, but such “Generals” don’t come along at a discount to their fair values very often.

When we make investments in an undervalued situation, we go in expecting it to come to fruition over at least a 3 to 5 year window, and of course sooner if things pan out and the market recognizes the fair price for these investments. However, in any single year, these investments can work in our favor or against us, and subsequently help us outperform or underperform the markets. Last year, while we had some investments that worked well for us, a few that worked against us dragged down our overall performance. In addition, in a rising market, our above average cash levels and the low relative returns these generated did not help us either. All in all, for many of our capital appreciation portfolios, these factors contributed to a lackluster calendar year 2012, relative to the markets. Year 2013 has begun off quite nicely though with our portfolios bouncing back in line year-to-date with the S&P500, despite the above average levels of cash in our portfolios.

What Worked For Us?

Let me begin with what went right for us in Capital Appreciation portfolios since Jan 2012 through the time of writing this review (2/15/2013). Of the top **five equity** performers in weighted average contribution terms (not including dividends), two were “Generals” — **Morningstar Inc. (MORN)** and **Brown-Forman Corp. (BF.B)** with returns of +18.7% and +21.6% during the period, respectively. The remaining three investments were “Special Situations” — **Symantec Corp. (SYMC)**, with a return of +40.6%, **Fair Isaac Corp. (FICO)**, with a return of +25.84%, and **Pfizer Inc. (PFE)**, with a return of +22.5% during the period.

The returns mentioned above capture the contributions during the period under discussion and an investment’s eventual contribution, since initial purchase, can be something very different and depends on when we exit our holdings. The table below lists all the positions where we took gains, partially or completely, during the aforementioned period:

TABLE 1: INVESTMENT DETAILS OF WINNING POSITIONS EXITED (JAN 2012 TO FEB 2013)

Investment	Ticker	Type	Dates Purchased (a)	Date Sold/ Maturity	Weighted Average Holding Period (Years) (b)	Annualized Return (%) / YTM (c)
Fair Isaac	FICO	Special Situation	Nov-09	2/1/2013	3.1833	30.63%
Sears Corporate Bond 6.7% d 4/15/12		Special Situation	May-09	4/15/2012	2.9278	19.15%
Mcgraw Hill	MHP	General	Sept 2008 to March 2009	2/5/2013	4.2065	15.89%
Pfizer	PFE	Special Situation	July 2008 to June 2010	1/18/2013	3.8293	15.88%
Microsoft	MSFT	Special Situation	Jan-09	1/24/2013	3.9944	14.92%
Sears Corporate Bond 7.5% d 12/15/12		Special Situation	Jul-08	12/15/2012	4.375	10.22%
Average					3.7527	

(a): Multiple prices , various dates as applicable

(b): Weighted Average Holding Period based on a 360 day calendar year and the various tax lots purchased during a holding period

(c): Approximate; Total returns including dividends and distributions assumed to be paid on sales date; YTM=Yield to Maturity for bonds

A point to note from the Table above—the average holding period before we “harvested” our investments has been in excess of 3 years. This speaks to the time it can typically take for an investment to come to fruition for us. Of the investments we exited, **FICO** did great for us while the rest did reasonably well. Our exit from **MHP** was determined by its fair value levels, the anticipated prolonged legal tussle with the DoJ (and various States), and the likely business model changes and financial penalties that tussle is likely to bring along. The other exits were all realization of fair market values, in our view.

..And What Did Not!

In the investment world, missteps are inevitable and we had a few during the period under discussion. While ups and downs are to be expected during the holding period of an investment, how we make out by the time we exit the investment is important. Positions where we took losses and walked away, partially or completely, during the period were as follows:

TABLE 2: INVESTMENT DETAILS OF LOSING POSITIONS EXITED (JAN 2012 TO FEB 2013)

Investment	Ticker	Type	Dates Purchased (a)	Date Sold/ Maturity	Weighted Average Holding Period (Years) (b)	Annualized Return (%) / YTM (c)
Federated	FII	Special Situation	Aug 2005 to Aug 2011	2/7/2012	3.7845	-2.38%
Legg Mason	LM	Special Situation	Nov 2007 to Feb 2010	10/4/2012	3.746	-14.44%

(a): Multiple prices , various dates as applicable

(b): Weighted Average Holding Period based on a 360 day calendar year and the various tax lots purchased during a holding period

(c): Approximate; Total returns including dividends and distributions assumed to be paid on sales date for return purposes; YTM=Yield to Maturity for bonds

We were reasonably successful in protecting our principal with **FII** but failed to do so with our investment in **LM**. **LM** was a case of our analysis being blindsided with what came along with the financial crisis of 2008-09. The crisis created an unforeseen capital obligation in the money markets fund business within **LM**’s stable of money management businesses and that left it struggling through the period we held the investment. The changes and challenges that the financial crisis brought about and was expected to bring about in the business models of both **FII** and **LM** made these investments candidates for us to say goodbye—we cut our losses and walked away from these in 2012.

During the period Jan 2012 through Feb 15, 2013, of the equity positions that pulled down our performance, **Hewlett Packard (HPQ)**, a Special Situation with a period return of -27.93%, **John**

Wiley (JWA), a General with a period return of -10.6%), **Dell (DELL)**, a Special Situation with a return of -5.6%), **McGraw Hill (MHP)**, a General with a return of -3.1%; we exited this position) and **Molson Coors (TAP)**, a General with a return of -2.5%) rounded up our top five weighted average negative performance contributors.

DELL deserves a mention here—a Special Situation that we have held for a weighted average time period of about 4 years now and currently trading very close to our net purchase price. While we have never been a fan of the businesses **DELL** is in, the valuation levels relative to our intrinsic value calculations (even after discounting for the subpar businesses and challenges faced by the company) attracted us to this investment in the first place. Given the buyout being orchestrated in the last few weeks by Michael Dell and company, our thesis appears to have been right—these players are trying to grab assets on the cheap while the market doesn't value the company appropriately—but not with a corresponding fillip to us from an investment return perspective. It will be interesting indeed to watch the action unfold as many institutional investors and current investors in **DELL** balk at the current price being offered in the buyout. A very likely scenario (as pointed to by the current price of **DELL** which is in excess of the offer price) is the upping of the buyout price, but not likely by much in my view. My expectation (if the buyout goes through) is that we will walk away from this investment with a very small return or breakeven, both scenarios below my expectations before I went into this investment.

Despite what looks to be a fairly valued environment for most assets, I remain on the lookout for opportunistic vehicles to put your capital to work. During such times, as history has taught us time and again, I believe patience will no doubt be a friend and a virtue. We continue to focus on managing your capital with a long-term perspective and a prudent investment philosophy in place. I thank you for being a valuable client and for trusting Ceera Investments, LLC with your family's assets. If you have any questions at all, I am just an e-mail or phone call away—please do not hesitate to get in touch.

Sincerely
Rajesh Chelapurath