GLOBAL RETURN
ASSET MANAGEMENT, LLC

January 31, 2017

**Re: 2016 Year in Review**

Dear Friends,

In 2016 we generated a 7.10% net return and ended the year with nearly 15% of assets in Cash.[1]

| **Performance Results (%)** | **2016** | **Q4** | **Q3** | **Q2** | **Q1** |
|---|---|---|---|---|---|
| Global Return | 7.10 | 4.03 | 2.61 | 0.97 | -0.64 |
| CAGR since inception[2] | 10.88 | | | | |
| Return since inception[3] | 51.15 | | | | |

Our Q4 2016 activity includes the following:

| | |
|---|---|
| New positions | 1 |
| Exited positions | 4 |
| Positions increased | 7 |
| Total positions | 22 |
| Cash balance | 14.73% |

In the letter below I provide details on our investing activities and an update on our portfolio. I then explain how the investment industry has confused the cause-and-effect relationship between risk and volatility. Following this is a discussion of how we view risk within a company. Finally, I end with an outline of our portfolio.

Please contact me if you have any questions or would like to discuss my investment strategy or risk management principles.

Respectfully,

Elliot Trexler

**PAST PERFORMANCE DOES NOT GUARANTEE FUTURE PERFORMANCE**

1. All data as of December 31, 2016. Actual Results. Non-levered. Net of management fee of 1.15% and expenses. See Appendix A for more information and Appendix B for important disclosures.
2. Compounded annual growth rate since inception, January 1, 2013. Net of management fee and expenses.
3. Return since Inception, January 1, 2013. Net of management fee and expenses.

## 2016 Activity

Before detailing our activity for the year, I want to comment on the endless debate of "passive versus active investing."

I think it's important to understand what constitutes "active" and "passive" investing. The conventional definition is that active investing is anytime a portfolio manager buys a group of stocks that don't mirror an index.[4] Conversely, passive investing is buying an exchange-traded fund (ETF) that mirrors an index. However, these definitions aren't robust.

For example, how long an investor holds an ETF and how different ETFs are weighted within an investor's portfolio could put "passive investing" squarely in the "active investing" category. As for active investing, is holding the same stocks for five years really "active investing"?

Global Return falls in the active investing category because the stocks we buy don't mirror an index. However, our average holding period is nearly four years, which we don't consider as active, and I'll wager many self-proclaimed passive investors don't hold ETFs this long. We also hold cash when we can't find opportunities that meet our strict criteria, which is an active decision, though some people might argue this is passive. Although, it requires significantly more discipline to sit with cash than to buy or sell an ETF.

Candidly, I think both strategies offer return-generating opportunities. For people who care to have it, my suggestion is to explore both options before deciding where to place your money and remember you can use both strategies.

With that said, for the full year, we entered six new positions, exited 10 positions, and increased 10 positions. Additionally, two existing positions were increased and then sold in later months and two positions were entered and exited during the year.

## Portfolio Update

At the end of 2016 we had 22 positions, 21 were common stock and 1 was a convertible warrant. I have two positions I'd like to sell but nowhere to place the proceeds; with nearly 15% of assets in cash it seems unreasonable to sell these positions, especially since they're yield on cost is about 4.6%.

As discussed in previous letters, a study of our returns indicated I need to reduce the number of positions we have and increase the amount of capital allocated to our highest conviction positions.

As the amount of capital allocated to each position increases, it's possible that the volatility of our portfolio increases but ideally so to should our results. It's also entirely possible our portfolio's volatility does not increase and I explain why in next quarter's letter. Irrespective, an increase in volatility doesn't worry me because volatility isn't risk and below I explain why.

[4] I'm a long-only domestic equity manager, so I'm not including other types of securities and short-selling.

**<u>Cause and Effect: Volatility Isn't Risk</u>**

The NYU Stern School of Business is home to the Volatility Institute. Per their website, "The Volatility Institute's mission is to develop and disseminate research on risks in financial markets and closely related topics in financial econometrics." If volatility interests you, I highly recommend attending their conferences or taking a few classes, they've been immensely helpful in shaping my views on volatility.

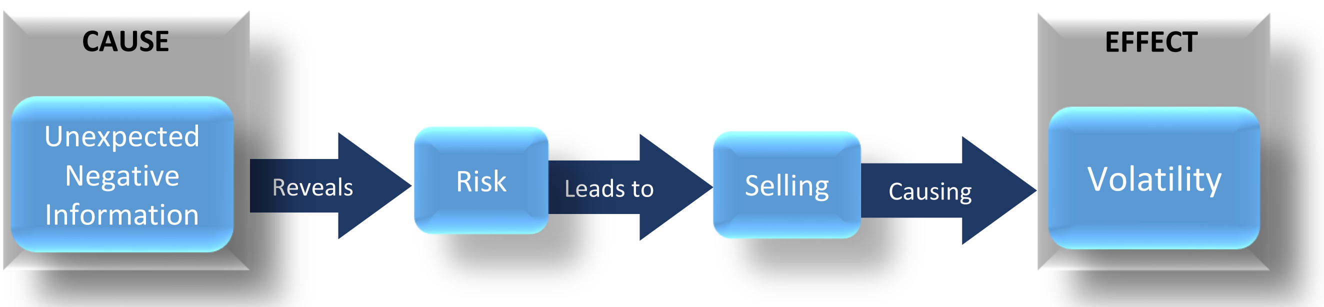
In the analysis below I only discuss "volatility as risk" when asset prices are declining. I've never heard anyone worry about volatility when asset prices were increasing, so there's no reason to discuss this.

Let's begin with defining volatility – it's the standard deviation of returns for an asset[5] or a measure of how much a return fluctuates around its mean[6].

What causes volatility? The genesis of volatility is unexpected negative information.[7] Following the release of unexpected negative information, market participants sell the asset which creates volatility.

Why does unexpected negative information cause volatility? Because the information reveals previously unknown risk.[8]

## The cause-and-effect relationship between risk and volatility




This illustration highlights the important distinction between risk and volatility – volatility isn't the cause of risk, it's the effect of risk.

Therefore, analyzing volatility or investing to volatility isn't the solution for reducing risk. The solution for reducing risk is to identify the <u>sources of risk</u> in an asset and understand how they could cause a revaluation of the asset.

In the following section I outline how I identify and analyze sources of risk in our prospective investments.

---

[5] Nasdaq Glossary.
[6] NYU Stern, The Volatility Institute. Volatility Analysis.
[7] An example is corporate earnings results that are below market expectations.
[8] I had a conversation with someone on this topic who argued, "The market will revalue a company lower because it missed earnings expectations, not because of some unknown risk." To this I replied, "The market was unaware of the risks that prevented the company from achieving earnings expectations." Unexpected negative information always results from risk.

## Identifying Risk in a Company

A business is a collection of risk variables. These variables include (but are not limited to) the business model, customers, suppliers, operating expenses, competitive advantages, demand/supply elasticity, competitive forces, etc. Importantly, risk variables directly impact a company's profitability and thus its valuation.


At Global Return, we attempt to identify each risk variable in a prospective investment. Once the risks are identified, we try to understand how changes in them could impact the company's profitability and by how much. We believe this is the key to minimizing losses – understanding the sources of risks within our assets' and how they could impact valuations.

## Types of Risk

Risks that reduce a company's value are *uncompensated* risk. The reason for this is obvious – an investor assumes the risks of an asset when he buys it, yet if the asset loses value because of the risk then the investor has bought uncompensated risk.

Conversely, risk that increase a company's value is *compensated* risk. Again, the reason should be obvious – companies take risks to generate returns and if they're successful the risk is compensated.

Finally, risk can be *fixed* or *fluctuating* and the example below shows how.

Here are several risk variables of a bricks-and-mortar retail company:

1. Capital sources
2. Fixed operating expenses
3. Real estate expenses
4. Competitive advantages
5. Industry capacity
6. Potential growth
7. Consumer trends
8. Price competition
9. Consumer spending
10. Multi-channel marketing

With a high-level of probability, can you determine which risks could change and how these changes would impact the company's profitability and thus its valuation?

1. Capital sources
2. Fixed operating expenses
3. Real estate expenses
4. Competitive advantages
5. Industry capacity
6. Potential growth
7. ~~Consumer trends~~
8. ~~Price competition~~
9. ~~Consumer spending~~
10. ~~Multi-channel marketing~~

The key to successfully answering this question is understanding the gargantuan difference between possible and probable. It's *possible* to quantify the risks that have been ~~deleted~~ but not with a high degree of probability, which means we can't determine the prospective investment's risk/reward ratio, so we must pass on the investment.

Some people might say, "Just look at past data." These people might be correct with some industries but not with the retail industry.

Look at risk variables #2 and #3 – these are *fixed* because they're unlikely to change without advance notice. Conversely, risk variables #8 and #9 are *fluctuating* because they regularly change and will do so without advance notice. This implies investors should approach fluctuating risks with more caution because they have a higher probability of igniting *unexcepted* risk, which will lead to a revaluation of the asset.

Risk variables can also change from *compensated* risk to *uncompensated* risk and vice-versa. For example, an increase in risk variable #8 and a decrease in risk variable #9, would reduce the retailer's ability to pay the expenses associated with risk variables #2 and #3. Therefore, the changes in variables #8 and #9 would convert variables #2 and #3 from compensated risk to uncompensated risk – and if you follow retail stocks you know why – because the market will quickly and dramatically revalue a retail company when it receives “unexpected negative information.”

Here we see how risk grows or diminishes as it and its ecosystem evolve. On their own, risk variables #2 and #3 may not be risky but now two fluctuating risks have impacted them and made them riskier. It’s the interaction between risk variables that makes risk amorphic and idiosyncratic, or in this scenario, transforms compensated risk into uncompensated risk.

This illustration offers several insights. First, risk exists in many different forms, is often latent, and can grow or diminish as it and its ecosystem evolve. Second, relying on past data to determine future results can be measured with *possible* outcomes but not always with *probable* outcomes. Finally, when certain risks coalesce, it’s possible that “unexpected negative information” is revealed causing market participants to revalue an asset, which leads to volatility.

What's the Solution?

Investors need to understand the risks imbedded in a prospective investment – what are they, how do they interact with each other and what could influence them that would ignite uncompensated risk? Following, investor’s needs to determine, with a high degree of probability, whether the current share price of the company offers a sufficient return given the inherent risks.

To us, investing is the act of purchasing risk. Therefore, security analysis <u>is</u> risk analysis, the two are the same. Obviously, our goal is to invest in companies with compensated risk that offers a high probability of achieving the risk/reward ratio we seek. We believe our approach to risk analysis is one of the hallmarks that has contributed to our success, our below-industry volatility and above-industry returns.

## <u>Conclusion</u>

I have no prognosis for what the market will do in 2017. As stock prices decline, the sentiment of my letters will change to bullishness. I yearn for declining prices because this is when our Cash is most productive – I can buy more stock with less money. It should not be ironic that declining prices offer reduced risk and increased returns, which, after all, is what every investor wants.

At the organizational level, I’m very happy with our progress. We continue adding clients to our already-impressive roster. Equally important, Marius Morar joined us last year and has been an incredible asset to me and Global Return. I’ll have much more to share about him in next quarter’s update.

Please contact me if you would like to discuss my investment or risk management strategy.

Respectfully,

Elliot Trexler

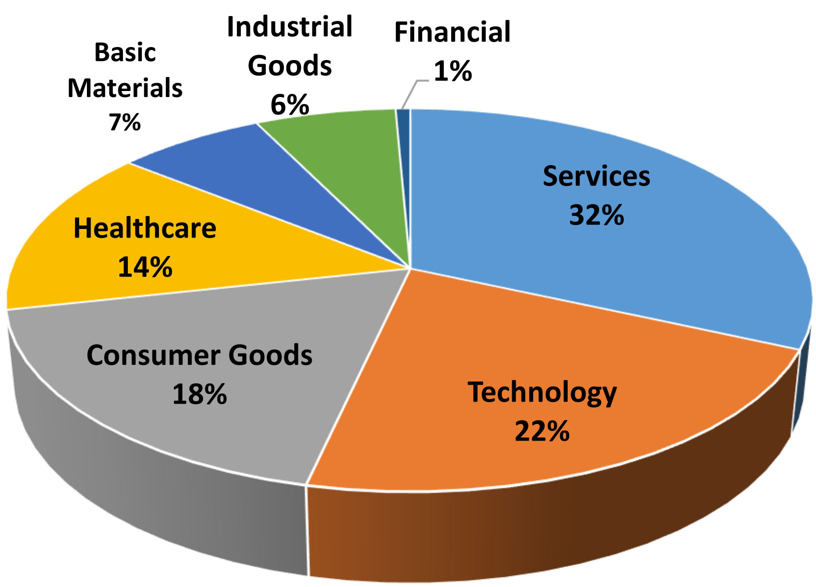
Elliot Trexler
etrexler@globalreturnam.com
646-838-8182

## Appendix A

## UNAUDITED MONTHLY RETURNS

| | | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov | Dec | YTD |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2013 | Gain or Loss | 4.86 | 0.78 | 3.71 | 2.49 | 0.02 | -1.06 | 3.51 | -3.66 | 2.94 | 5.12 | 1.19 | 1.41 | 23.08 |
| | Cash Balance | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.06 | 5.28 | 5.27 | |
| 2014 | Gain or Loss | -3.50 | 4.04 | 2.00 | 0.30 | 1.89 | 1.73 | -1.80 | 2.38 | -0.40 | 2.00 | 3.74 | -0.36 | 12.40 |
| | Cash Balance | 9.14 | 5.00 | 4.90 | 8.37 | 8.22 | 8.08 | 11.83 | 10.97 | 17.08 | 15.30 | 12.66 | 13.92 | |
| 2015 | Gain or Loss | -2.77 | 5.25 | -1.34 | 0.72 | 2.48 | -1.71 | 1.12 | -3.53 | -2.51 | 4.05 | 0.60 | 0.04 | 2.02 |
| | Cash Balance | 23.83 | 17.72 | 14.67 | 14.57 | 13.34 | 34.06 | 28.63 | 32.24 | 30.96 | 28.16 | 27.06 | 28.50 | |
| 2016 | Gain or Loss | -2.02 | -1.79 | 3.25 | 0.98 | -0.38 | 0.37 | 1.83 | 0.27 | 0.50 | -2.76 | 4.93 | 1.96 | 7.10 |
| | Cash Balance | 31.29 | 20.97 | 19.79 | 20.87 | 22.07 | 19.02 | 13.37 | 14.19 | 18.28 | 15.14 | 14.15 | 14.73 | |
| CAGR[9] | 10.88 | | | | | | | | | | | | | |
| ITD[10] | 51.15 | | | | | | | | | | | | | |
| Avg. CB[11] | 13.62 | | | | | | | | | | | | | |

## Allocation by Sector




## Portfolio Information

| | |
|---|---|
| Number of Holdings | 22 |
| Average Turnover | 27% |
| Cash Balance | 15% |
| Median Market Cap (billions) | $26 |
| Avg. Weighted Market Cap (billions) | $59 |
| Dividend Yield (at Cost) | 2.50% |

Data as-of December 31, 2016. Figures are rounded.

**PAST PERFORMANCE DOES NOT GUARANTEE FUTURE PERFORMANCE**

[9] Compounded annual growth rate since inception, January 1, 2013. Net of management fee of 1.15% and expenses.
[10] Return since inception on January 1, 2013. Net of management fee and expenses.
[11] Average cash balance since inception, January 1, 2013.

**Appendix B**

**IMPORTANT DISCLOSURES**

This document is confidential and intended solely for the addressee. It is intended for information purposes only and should be used only by sophisticated investors who are knowledgeable of the risks involved in investing. This document does not constitute an offer to sell or the solicitation of an offer to purchase securities and may not be published or distributed without the express written consent of Global Return Asset Management, LLC ("Global Return"). An offer may be made only by use of a confidential private offering memorandum and only in jurisdictions where permitted by law. This information is not intended to be a description of the risks of an investment in any fund (the "Fund") or separately managed account managed by Global Return or its investment strategies. This material is not meant as a general guide to investing or as a source of any specific investment recommendation and makes no implied or expressed recommendations concerning the matter in which any accounts or the Fund should or would be handled.

An investment in a Fund or separately managed account managed by Global Return is speculative and involves a high degree of risk. Global Return is a newly formed entity with no operating history. Funds managed by Global Return may also have limitations on investors' ability to withdraw or transfer their interests in the Fund and no secondary market for the Fund's interests exists or is expected to develop. All of these risks, and other important risks, are described in detail in the Fund's private offering memorandum and separately managed account investment management agreement. Prospective investors are strongly urged to review this private offering memorandum and the investment management agreement carefully and consult with their own financial, legal and tax advisors before investing.

There can be no assurances that the Fund or separately managed accounts managed by Global Return will have a return on invested capital similar to the returns of other accounts managed by Global Return because among other reasons, there may be differences in investment policies, economic conditions, regulatory climate, portfolio size, and expenses. The fact that other accounts managed by Global Return have realized gains in the past is not an indication that the Fund or separately managed accounts managed by Global Return will realize any gains in the future. Prior performance is not necessarily indicative of future results.

The information presented herein is confidential and proprietary and may not be disclosed by, or on behalf of, you to any third party without the prior written consent of the Global Return.