NOVEMBER 2013 INVESTMENT COMMENTARY

THE AUDACITY OF KEEPING IT REAL

I have had the opportunity to sit down with several new clients over the past couple months. These conversations have centered on the portfolio management process and design methodology. This is a subject matter that I am always more than happy to discuss. For me, these conversations are always thought provoking and cause me to reflect on how our process is perceived.

Having over 15 years of portfolio management experience, I have to admit that it would be much easier to convey what we do within portfolios if our process could be put in a style box or an asset class category. These labels, which many investment managers feel compelled to conform to, include large-cap growth and small-cap value, etc., and extend to trading strategies such as: sector rotation, market neutral, global macro, and momentum based investing. From a sales and marketing perspective, these labels are "the way to go."

CUSTOMIZATION CHALLENGES CONVENTIONAL LABELING

I have developed a portfolio management approach that, by design, cannot be readily labeled. This process developed out of my insistence that an investment portfolio should be custom built to suit the individual client. This turns the conventional approach used today on its head, which takes existing mass marketed portfolios and then best fits a client to the most suitable choice. The inability to readily label my process was apparent earlier this year when a business consultant for one of my clients reviewed that client's portfolios. The consultant called me to say that he did not know how to categorize the portfolio for comparative purposes. In other words, the portfolio was both eclectic and sufficiently concentrated that it was not easily matched up to a particular broad market benchmark or Lipper peer group. Throughout this discussion I could not help thinking that the StaufferWilliams portfolio design process, which I have developed over many years, is accomplishing exactly what it was designed to do. This process is uncompromising in its primary goal of attempting to calibrate investment risk and return objectives to each individual client's needs. Since a client's needs rarely line up with a broad market benchmark, our portfolios are both customized and purposefully eclectic, thereby making market benchmarking virtually meaningless.

LEGENDARY INVESTORS KEEP IT SIMPLE AND KEEP IT REAL

The customization that we insist on is unique in this time of cookie-cutter investment management services, however the under-pinning's of the investment process are rooted in the common elements found when observing the best investors over the last half

century. Having studied great investors such as Peter Lynch, Mario Gabelli, Marty Whitman, David Swensen, and of course Warren Buffet, they eschew narrow categorization and never discuss concepts such as tracking error or sector over-weights and under-weights. In addition, these legendary investors stick to fundamentals (keep it real) and will rarely include words such as algorithm, global macro or even asset allocation in describing their process. The one thing each of these legendary investors have in common is maintaining a focus on seeking out underpriced securities (value) and narrowing down the universe of suitable investments to those that can easily be understood. For example, below is some priceless investment wisdom from the five who I mentioned above:

PETER LYNCH

» "If you pigeonhole somebody and all they can buy are the best available growth companies, what happens if all growth companies are overpriced? You end up buying the least overpriced ones."

» "My premise has always been that there are good stocks everywhere."

» "I don't think that with great stocks you need a Cray super-computer or an advanced Sun Microstation to figure out math."

MARIO GABELLI

» "We're buying a business and a business has certain attributes. We're not buying a piece of paper and we're not buying soybeans."

» "It's kind of the blending of a series of judgments with some mechanical and arithmetic exercises."

MARTY WHITMAN

» "[Wall Street spends too much time.] Making predictions about unpredictable things."

» "Over-diversification is a proxy for knowledge - and a poor proxy at that."

DAVID F. SWENSEN

» "Security selection plays a minor role in investment returns, because investors tend to hold broadly diversified portfolios that correlate reasonably strongly to the overall market."

WARREN BUFFETT

» {Ben Graham's} "Mr. Market allegory may seem out-of-date in today's investment world, in which most professionals and academicians talk of efficient markets, dynamic hedging and betas. Their interest in such matters is understandable, since techniques shrouded in mystery clearly have value to the purveyor of investment advice. After all, what witch doctor has ever achieved fame and fortune by simply advising "Take two aspirins?"

For those clients who have worked with me for several years you will recognize the names of most of these great investors because I have quoted them on many occasions. I am drawn to the simplicity and purity that these legends espouse when questioned about what made them as successful as they have been within the investment industry.

WIN BY LIMITING COMPLEXITY

This simplicity drives the active management that is utilized in our client portfolios. Simplicity even comes into play if and when we choose to utilize a third party managed fund or private investment within a portfolio. If a pooled investment strategy is utilized, it will not be an opaque quant or global macro hedge fund, derivative fixed income security, or complex option strategy. The reason is that these types of strategies are typically high priced and inherently complex, but at the end of the day, they rarely add value within a well-constructed fundamentally driven portfolio. Most of these strategies were originally developed to be used as hedging solutions for a narrowly defined category of risk and not as portfolio holdings for individual investors. However,

because many individual investors want to believe that there is a secret formula for investing success that is only available to a select number of sophisticated investors, when they are presented with an "impressive" sounding, but complex strategy, their curiosity is peaked. This curiosity is capitalized upon by the person selling the strategy who will be more than happy to play into the curiosity of an investor who is seeking out that "secret" formula to investing success.

Warren Buffett summed up this tendency to be attracted to what is complex and impressive sounding when he said, "there seems to be some perverse human characteristic that likes to make easy things difficult. It's likely to continue that way. Ships will sail around the world but the Flat Earth Society will flourish". Likewise, the sales/asset gathering mechanism at the center of the modern day investment management industry will continue to manufacture ever more complex and expensive strategies to sell, while fundamental value oriented investors continue to quietly produce impressive long-term results for their clients by sticking to what been proven to work and stands the test of time.

On the subject of complex and over-priced investment strategies, in the October 28th edition of Barron's, within the magazine's monthly report of Hedge Funds, it was interesting to note the seemly random performance disparity that exists within hedge funds employing like strategies. Most hedge funds are typically employing sophisticated trading strategies executed by the most skilled traders in the industry. Given this, one would expect in a year such as 2013, that impressive results would be easy to find. Below is a sampling from this report of the YTD performance of hedge funds with at least $50 million under management:

1. One of the largest and most admired hedge funds is the Bridgewater Pure Alpha Strategy fund managed by Ray Dalio. Year-to-date the Pure Alpha Strategy 18% volatility fund is up 4.1% and the 12% volatility fund is up 2.8%. Both of these funds are managed by, what is considered by many to be, the best "global macro" team in the business. Even this "all-star" team of analysts and traders seemingly guessed wrong from much of 2013.

2. On the other hand, the Blue Sky World LP, which also utilizes a global macro strategy, appears to have guessed right this year as this fund is up 93.6%.

3. When looking at hedge funds which profess to utilize a much more traditional approach to equity investment classified as "long-only equity", the results were remarkable only to the extent that these highly compensated large investors do not appear to have been able to add value beyond what the broad market has produced YTD. For example:
    a. Cambrian Global Fund, Ltd., a smaller hedge fund employing a long-only equity strategy has produced a YTD total return of 18.1%.
    b. MFS Investment Global Equity has generated a total return of 19.1%.

4. So as to not be accused of leaving out the more flexible hedge funds that employ a "multi-strategy" approach, the largest multi-strategy hedge fund, Millennium International Ltd. generated a YTD total return of just 9.1%. This was very good compared to a multi-strategy fund run by Renaissance, another very large hedge fund company. The renaissance Institutional Diversified Alpha fund returned a -1% YTD.

The reason that I highlighted this information on the performance of various hedge funds is because I have witnessed the randomness and ineffectiveness of sophisticated hedge funds over the course of my career, and 2013 appears to reinforce this observation once again. That being said, I am always struck by the durability of the allure of these strategies, which rarely

seems to wane among high net worth investors, in spite of poor risk and cost adjusted performance records for the majority of hedge funds.

In many of the client accounts where I include an allocation to "non-traditional" strategies, I will utilize the Ivy Asset Strategy Fund (IVAEX), as well as specific non-traded strategies where appropriate. I have utilized this Ivy fund for many years and thus far in 2013 the fund, which carries a low 0.74% internal expense ratio and currently sports a 2.59% dividend yield, has had a total return YTD of approximately 13.5%. This fund can own stocks, bonds, commodities, real estate, etc., thus I would compare it to a "multi-strategy" hedge fund. The Ivy fund, compared to the "multi-strategy" hedge fund results mentioned earlier, is example of how "keep it simple", and low-cost, can yield superior results compared to highly complex and expensive hedge funds.

FACING CHALLENGES AND OPPORTUNITIES -- UNIQUELY CAPABLE OF SUCCESS

Staying on the subject of what works and what does not, the next 12 to 18 months are likely to be more challenging as a result of how well equities have done this year. What I am focused on right now, and attempting to both mitigate and take advantage of, are:

1. The persistent overhang of QE "taper" anxiety and its effect on bond yields, emerging markets and currencies.

2. A fully valued U.S. stock market in a slow economic growth economy.

3. Stubborn deflationary pressures globally.

4. Slow European economic recovery dependent upon the health of China's economy.

5. The fragility of the Japanese Yen caused by fiscal and monetary policy decisions which are affectively an "all-in" bet to stimulate growth and inflation.

These challenges present both risks and opportunities within portfolios. On one hand investors are not facing a mania driven bubble like the dot-coms of the late 90's, or highly leveraged housing related securities that almost destroyed the financial system five years ago. However, today the challenge is that both broad equity and bond markets appear to be fully valued at best. With the two primary asset classes, that most investors rely upon for growth and diversification, offering limited opportunity on a broad market basis, finding value will require both unconventional investments and security selection process which seeks out special situations and value.

This type of environment is exactly when being unconstrained and objectively focused upon identifying value, wherever it can be found, will provide portfolios the greatest opportunity to continue to produce attractive risk adjusted real returns.

It is always gratifying to have portfolios do what they were designed to do, and 2013 has been another gratifying year so far. But all of my focus is on preserving and hopefully building on 2013's gains over the next 12 to 18 months. As the end of the year approaches, StaufferWilliams Asset Management is increasingly being sought out by other advisers within the Coastal Equity system of advisers to supplement their practices with actively managed investment account capabilities. This new avenue of business opportunity will require us to hire a "junior" portfolio manager/research analyst. I hope to finalize that hiring decision within the next 6-8 months. This staff addition will position the company to grow and fulfill my desire for continual improvement in the investment process.

Coincident with this growth and expansion, Jonathan Williams has transitioned away from his responsibilities

with StaufferWilliams and has accepted an employment opportunity with a newly formed “family office” advisory firm. With this transition, and the growth that the business is experiencing, I am determined to make sure that there will not be any interruption in the quality of service and the investment management process that we pride ourselves on. At some point over the upcoming months, I will likely move away from the StaufferWilliams Asset Management branding of the company toward a name that better reflects our value proposition and “what we do.”

The StaufferWilliams Asset Management organization’s success has exceeded my expectations and I am much energized to continue to improve our capabilities and grow with the support of our partners Coastal Investment Advisory and Coastal Equities. These organizations have been providing excellent back-office administrative and compliance support that allows me to focus on growth, client service and the investment process.

CURT R. STAUFFER
717 877 7422

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