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For much of my life, I grew up with the sense that the Holocaust was an event that should be continually studied and reviewed so that future generations would not repeat such a vile act or allow it to be repeated. Eighty years later, world events continue to point to the properness of pounding this message home.

The relevancy here is in regard to the study of economics and the global creation of wealth. While it can argued that the application of economic thought is often counterproductive to the creation of wealth, some basic understanding of these concepts is vitally important not only to the dollar value on your account statement, but also to the general well-being of the 7.4 billion of us on the planet. It is simply preposterous to argue that the stupendous advances in the quality of living in any part of the world post-WWII have not been directly correlated to the adoption of greater freedoms and more open and capitalist societies. It is our great shame as a country that we do not celebrate this success, and it is shameful that we do not relentlessly embed this thought in our educational system—starting at the earliest age possible. A lack of perspective on our collective accomplishments is the only way to explain the sheer idiocy that is pounding our ears now, and will be continuing over the next 7 awful months in regard to economic policies ranging from free trade to tax policy to regulation to the greatest canard of our time: "inequality." And there should be deep sadness and shame shared by all of "us"—including the leadership of our country, its businesses, and our political institutions—that so many are carrying signs to support policies whose adoption would hurt the sign holder the worst. The minimum wage is not $15 per hour; it is zero at unemployment. And contrary to what is espoused by the Governor of California, it is borderline immoral to pass legislation that "economically…may not make sense."

The corollary of that statement is that the adoption of the Federal Reserve's ZIRP (Zero Interest Rate Policy) or NIRP (Negative) is not the solution to what actually ails us, or what some perceive to be ailing us. Monetary policy cannot be effective in the face of truly awful fiscal policy. The economy needs stable, less burdensome tax policy; stable and fewer regulations; more free trade (not less); and freer markets that provide legitimate pricing signals that enable businesspeople to make intelligent decisions about investing capital, taking risks, and hiring people.

Having miserable fiscal policy and relying 100% on zero interest rates to stabilize the economy is exactly why there is a cyclical bump in the appearance of economic inequality. What does one think happens when asset markets are elevated by monetary policy, and fiscal policy is destroying the confidence level of businesses? Things are good for our clients; not so much for those who built our building or who currently clean it. If it were all about low interest rates, President Obama would have a 96% approval rating, unemployment would be negative, and the Dow would be at 56,000.

Destructive fiscal policy zaps the life out of our entrepreneurial animal spirits, with the exception of a few mythical animals that reside in Silicon Valley. Until there is some stability in business policy, we will continue to under-earn our economic potential and financial markets will remain precariously supported and propelled by uncharted monetary policy. And not to harp on math, but an economy that grows at 1.5% instead of 2.5% is not missing the mark by only 1%, it is missing it by 40%. The uncertainty regarding how the Great Monetary Experiment will end—and end it will—remains an investor's biggest source of "known unknown" risk in financial markets.

One does not fix this by holding "corporations" responsible for not investing or by dragging CEO's in front of Congress to account for themselves. One does not help matters by saying private companies should invest in their businesses for appearance's sake versus holding cash overseas or paying dividends and intelligently buying back stock. I will repeat what I have said in previous letters: I don't think I have ever met a CEO who would not rather invest internally in capital expansion than buy back stock or pay a dividend. If they are not, then they are nervous about something. In a world always full of uncertainty and replete with anti-business fervor—and with low interest rates causing any idiotic acquisition to be "accretive on a non-GAAP, EPS basis"—this country is better off as a whole with companies buying back stock rather than investing in political nameplate projects like Solyndra.

The Pfizer/Allergan deal is a classic example of the problems we are facing as a country that result from fiscal mismanagement. No one will argue that our tax code is wonderful and creates a fair system of incentives. The CCH Standard Reporter Tax Guide ran 1,500 pages in 1975. It now runs 74,000 pages. Here is what the current administration doesn't understand about business: you can discuss, lobby, and legislate large and visible changes in the tax code. Even if it's an uneconomic and counterproductive change, everyone sees it coming and can react as private citizens and businesses. What you cannot do if you want to stimulate the economy is pull winners and losers out of thin air and retroactively and deliberately change the tax code to target X person or Y deal.

Another quick and somewhat related blow to rational thought was highlighted in the recent opinion by Judge Rosemary Collyer to rescind MetLife's designation as a systematically important financial institution. Her opinion detailed how the government changed rules along the way, pretended it didn't change anything, and refused to do any cost-benefit analysis of regulation or the impact it actually might have on MetLife's financial stability. In other words, they completely made it up as they went along and HUGE kudos to MetLife's CEO Steven Kandarian for fighting back against the white-collared, but still jack-booted thugs of lawyers and regulators that are infecting our economic environment. It is another example of how the current administration has arguably had the worst economic "touch" since Hoover. Let's just call it: Treasury Secretary Jack Lew makes the Justice Department look good in terms of his willingness to utterly subvert common sense and fact-based decision making in the name of politics.

But just to be fair, the arbitrariness of government is as old as the chariot and Roman legions, and it crosses all party lines. It was the arbitrariness of the Bush administration decision to let Lehman go under while Bear Stearns and Washington Mutual were "saved" that was the final straw in the 2008 financial crisis mess that drove the world from a serious problem into all hell breaking loose. And as ALL of us should realize, the present choices facing us in 2016 on either side of the aisle are simply awful or an awful continuation of the same.

On the more immediate front, the first quarter of 2016 was a classic Rip Van Winkle quarter that should serve as a lesson for us all. If you needed 3 months to sleep off New Year's Eve extravagance and woke up in early April, you would have thought things were generally unchanged—nothing going on. But if you had made it into the office,

you might have noted that on February 11th, the Russell 2000® was already down 15.9% year to date and there was a distinct whiff of panic in the air. (Panic-Scented Candles: a candidate for our 2016 client gift.) For only the second time in 5 years, we sent out a "begging for money" letter (we will discuss the results of that effort later on). With funds available, we leaned into existing names, brought in several new stocks that also furthered our "cyclical problems are buyable" mini-theme, and ended the quarter with pretty decent smiles on our faces as the stock market as a whole is improbably close to all-time highs.

As we look forward, the vicious rally in cyclicality has taken some immediate returns off the table, and yet we see many of the same problematic issues. Stock and bond markets rallied the second the Federal Reserve abandoned its plan to gradually raise interest rates in 2016. The arbitrariness in their thinking should bug you as should your peer's knee-jerk reaction to pursue short-term "risk-on" or "risk-off" strategies based upon the current whims of the Fed.

And on another note, year-end Annual Reports and Proxy Statements are out. We have commented endlessly on the complete butchering of what constitutes a proper financial statement in the name of "adjusted" GAAP earnings. According to a recent Wells Fargo analysis, there was a 33% difference between GAAP earnings and what companies like to tout in headlines as their "adjusted" earnings. In the meantime, the SEC is hard at work making sure companies have provided the appropriate disclaimers on their risk from climate change. But there is something more insidious here that frankly is an obvious natural evolution of the proliferation of non-GAAP metrics. The trend du jour is to pivot toward "performance-based" compensation. More and more companies claim that 70% of compensation is based on performance. However, what CEO cannot hit a target that is adjusted as follows:

> For fiscal year 2015, the adjustments to EPS, revenue and operating income, as applicable, were as follows (i) exclusion of acquisition related charges, (ii) exclusion of restructuring and other related charges, (iii) exclusion of the impact of certain acquisitions, (iv) exclusion of the impact of changes resulting from foreign currency exchange rates (with respect to performance measures at the business unit level), (v) exclusion of certain corporate allocations (with respect to performance measures at the business unit level), (vi) exclusion of income tax benefits associated with the settlement of audits of prior year income tax.

This is the new normal and it stinks. We are now getting calls from teams of executives soliciting our vote on non-binding "Say on Pay" initiatives. A note to those who are looking for our support: while we recognize the tyranny of the proxy firms' models on pay, don't bother calling us. We read the proxies carefully, we have our opinions, and we will write you a private letter giving our two cents if we think you can and should do better. Oh, and if your pay doesn't go down when your earnings go down, double don't call us—you will not like what you hear.

Getting back to our "call for money" letter (covestreetcapital.com/why-you-should-give-us-money-right-now/), we expected to be early and have six months of people laughing in our faces versus the 20 percentage point swing we enjoyed in existing small cap portfolios. This market's move puts a number of our more cyclically-oriented companies a bit over their skis as corporate profits at large don't seem like they are on the verge of a v-shaped inflection point. There remain a number of opportunities, but we continue to think defensively.

What is interesting about this environment is that in the past, when our performance has hit that moment when the bad quarters dropped off and the good quarters showed up in a relatively tight mathematical link, we got a fair amount of attention from well-meaning strangers asking for our immediate assistance in our chosen profession. Let's just say what we are seeing now is relatively sparse given the conditions noted above.

Of course, that could mean that the world has finally educated itself to NOT hire money managers on the basis of near-term performance. Or…it could be today's common theme of "everything that can be and should be indexed is moving in that direction, and as a result active management is dead." As we have said before, it is somewhat of a positive thing for investors at large to finally be able to purchase "beta" or market exposure at a low fee versus what masquerades as active management at a high fee, although it still amazes us how the hedge fund industry

manages to continue to pull off the same trick at much higher fees.

	Active			Passive		
Estimated Net Flows	**Feb 2016**	**1 Year**	**Assets**	**Feb 2016**	**1 Year**	**Assets**
$Mil			$Bil			$Bil
US Equity	(11,371)	(180,651)	3,275	6,921	104,159	2,310
Sector Equity	(1,364)	(6,324)	340	(3,852)	10,620	324
International Equity	4,122	29,657	1,362	468	161,424	760
Allocation	(5,452)	(41,804)	1,052	24	1,358	52
Taxable Bond	(4,920)	(99,226)	2,168	12,906	87,078	786
Municipal Bond	4,946	18,204	605	550	4,856	24
Alternative	3,715	13,688	163	530	7,865	43
Commodities	799	(1,885)	21	5,534	4,630	59
All Long Term	**(9,521)**	**(268,337)**	**8,985**	**23,082**	**381,992**	**4,357**
Money Market	41,629	106,762	2,779			

Source: Morningstar

While this chart appears to imply that the final nail has been placed in active management's coffin, there are asset classes where "skill" can be employed and the playing field can be tilted in the direction of a thoughtfully active investor. One such example, not so coincidentally, is small cap value, where the academic holes in efficient market theories still persist: thousands of possible ideas, conventional fear of illiquidity or oddball companies, less and less official research converge, and the ability to own stocks not held by index funds. Said more simply, the fewer people who are looking at something, the more probable it is that you might be able to see something that others have missed or ignored. And the more it is becoming the institutional imperative to NOT buy something that is not in an index fund, the more that field is tilting towards us.

So if we limit our assets under management, concentrate our investments, and partner with smart, understanding, and long-term pools of money, we think there is a lot of money to be made—no matter how uncomfortable it is to be the LAST active manager standing.

— Jeffrey Bronchick, CFA | Principal, Portfolio Manager

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