INSIGHT

MANCHESTER
CAPITAL MANAGEMENT, LLC

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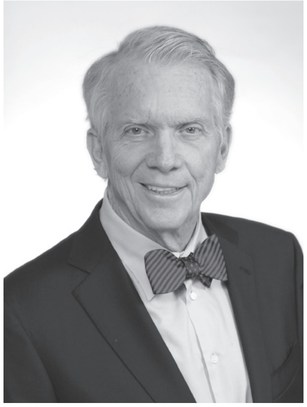
INSIDE THIS ISSUE:

GLOBAL GROWTH

From the Investment Committee

Investing in foreign markets can feel uncomfortable and, at times, discouraging, when domestic markets do well, as they did in 2014. Indeed, investors in almost every country have a "home" country bias in their portfolios, allocating a disproportionate weight to the financial markets where they reside. They tend to trust what is closest or most familiar, rather than what offers the best prospects.



Last year, U.S. investors did well with their bias, while their European counterparts suffered. This year, it looks like a perfect reversal, with Europe enjoying double digit-returns while the U.S. markets seem to be consolidating the gains of the last six years. To the extent possible, our task is to resist emotion and employ academic research, experience, historical data, and deductive logic to invest where there is the greatest opportunity for risk-adjusted returns.

We continue to seek investments abroad, including developed economies (Europe, Japan, and Australia) and developing economies (such as China, Vietnam, Bangladesh, Nigeria, and Panama) primarily because they are attractively valued and over time are uncorrelated with our domestic stocks and bonds. Such allocations are best implemented by managers with experience and expertise in the specific countries. And in the debate regarding the merits of passive versus active money managers, the foreign markets offer perhaps the best opportunity for skill to outperform a passive (indexing) approach.

The reliability of financial data on foreign investments can be suspect. But domestic corporate reporting can also be distorted by intent (CFOs trying to look good), by fraud (Enron is memorable), and by the unexpected black swan, such as the 50% decline in oil prices. Long-term investing requires trying to identify the major trends that will impact markets and persist despite interim events. We believe that a major driver of global economic growth will be the demographics of emerging economies.

The U.S. population is 4% of the globe's population, yet it makes up 50% of global financial market value. This relationship will change dramatically in the future as the global population grows increasingly productive, spurred by smartphones in rural Africa, the democratization of and increased access to information, and new capital invested in developing economies.

Together, these forces have lifted people out of poverty into fulfilling lives. The weekly magazine *Economist* recently reported that 80% of the world's population will have a smartphone by the year 2030. Those smartphones will have greater processing power than the most advanced supercomputers of only 25 years ago.

Business remains the greatest force of social change in the history of humanity, and capital is the necessary spark that lights that fire. The last several decades have seen extreme poverty across the globe cut in half, while child mortality has improved, life expectancy has increased dramatically, family income has grown, human rights of both men and women have advanced, and almost every measure of the quality of human existence has benefited from economic progress.

There are now approximately 8 billion people on the planet, and the number could level off at 10 billion to 11 billion as population growth ceases. Indeed, birth rates have stabilized as women no longer need to have large families in the hopes some will survive. Women can now enter the workforce to pursue careers formerly denied by law and by circumstance. The number of children has already leveled off at about 2 billion, and has ceased increasing because families now typically have only two children per household. The increase in global population comes from increased life expectancy: More people will live longer lives, into their 70s and beyond.

As we study where to put our capital to work in an uncertain future, we can be confident that one durable trend will be an improving global economy driven by slowing population growth. Technology will advance human productivity in ways not yet imagined but certainly a continuation of recent advances. The fastest growth will be in places like Asia, Africa, and Latin America where the markets are less advanced than in the United States. The best investments are often those made at the beginning of trends when values are modest, such as the developing economies of the world.

For further information on these trends seek information at www.gapminder.com or search for "Hans Rosling" for his many TED talks and YouTube videos on the global revolution, which is equal to or greater than the changes wrought by the Industrial Age.

PRIVATE EQUITY AND VENTURE CAPITAL: DO YOU GET PAID FOR THE RISK?

by Daniel Goldstein, *Senior Managing Director*

Leading up to the era of tech, and before the tech bubble, the most progressive high-net-worth private investors and sophisticated institutional investors were adding returns that were multiples of public market returns by investing in high-risk venture capital and private equity. Are investors today being paid for that risk?

Venture capital and private equity are both private investments in private companies intended to fuel growth and create shareholder value, appreciation, and return. Typically, venture capital refers to investments made in companies in earlier stages of formation and growth; private equity typically refers to investments made in better-established companies. Venture capitalists tend to take smaller equity positions, often sitting on the company's board to help direct the growth. Private equity firms invest through both equity and debt structures, often taking very large positions in invested companies or even buying them out. Venture capital and private equity investments are inherently riskier than most public equity investments.

Within a fund structure, what were the traditional returns to an investor in this asset class? Roughly one-third of underlying investments would be written down to zero, one-third would just return the investor's capital, one-third would produce returns – and one investment would be the star that produced outsized returns, carrying the fund's total performance to the IRRs and multiples sought. However, more recent funds have not necessarily followed this pattern. Over the past several years this asset class has lagged public markets, especially considering the additional risk taken.

The Kauffman Foundation of Kansas City has been a very active investor in this asset class for over 20 years. In 2012, it published a report titled, "We Have Met the Enemy and He Is Us." The report concluded that institutional investors were in large part to blame for having created a broken system of misallocation of capital that did not adequately reward venture investors for risk taken. One factor that significantly accounts for the lackluster returns of this asset class as a whole is the wide dispersion between top-quartile and bottom-quartile funds. Dispersion among public market managers is so narrow that for some asset classes, it is difficult to justify the cost of active management.

What can an investor do? Great diligence must be used in choosing managers in the venture capital and private equity asset class. Betting on "unicorns" (elusive billion-dollar startups) is not a sustainable way to achieve returns. Nor is following a do-it-yourself approach of selecting individual investments off publicly accessible angel investment platforms – analogous to chasing returns through day trading instead of strategic portfolio construction.

Should investors abandon venture capital and private equity as asset classes? We say no – as long as the appropriate discipline is applied. Venture and private equity funding for private companies will continue fueling economic growth and will continue rewarding smart investors for taking on the risk of funding innovation and growth at the private company stage. Venture firms and investors burned by previous lackluster returns have consolidated and regrouped, and they are deploying capital with more efficient objectives and metrics. There will still be great dispersion, the very definition of inefficient markets, and that is precisely why there is also great opportunity to be found.

FOLLOW THE MONEY: EVALUATING ALIGNMENT OF YOUR INTERESTS WITH THOSE OF YOUR ADVISOR

The financial markets offer a broad, almost bewildering, set of investment opportunities, and concomitant risks, to individual and institutional investors. The creative prowess of our industry also extends to the myriad sources of income which accrue to financial specialists from the development and distribution of these instruments.

This article offers a "tasting menu" of the types of fees and sources of income that are prevalent in our industry with the intention of arming our readers with tools to reduce fees in their portfolios and increase alignment of interests with their advisors.

Pure family offices and independent advisors, such as Manchester Capital Management, provide the simplest and most aligned fee arrangement. Our primary source of income is the transparent advisory fee we charge our families on a quarterly basis. We take pains to continually monitor and, where possible, reduce every type of fee that may be charged to our firm or to our clients by a third-party asset manager, custodian, etc. We also ensure that our team is measured and compensated in a manner that encourages teamwork and prioritizes the interests of our clients.

Many participants in our industry are product providers, distributors, or hybrid businesses that attempt to combine delivery of products with delivery of advice. They are certainly rendering an essential service because without them, advisors such as Manchester Capital would have no instruments with which to build portfolios for their clients. Many are pure asset managers that charge competitive asset management and administration fees directly to their clients, and perhaps add performance fees if they reach certain performance targets. Many of them have their own assets invested alongside those of their clients, as we do at Manchester, to further enhance alignment of interests.

The types of income arrangements that raise more concern about alignment of interests are those in which the purported advisors are receiving income, related to their client activity, which stems from a source other than their clients. In this case, it is legitimate to ask whose interests they place first. For example, most retail share classes of mutual funds (Manchester Capital prefers

by Michael Warszawski,
Senior Managing Director

lower-cost, institutional-share classes) charge their client, in addition to asset management and administration fees, 12b-1 fees (the industry term for marketing fees). These are usually subtracted from the value of your fund on a daily basis and periodically remitted to the agent who sold the fund to you. Are these agents recommending the funds that best meet your needs, or those that extract and remit the highest marketing fees?

If your portfolio includes single bonds, many brokers act as principal rather than agent in offering these, meaning that, rather than shopping the bond markets for the lowest price on your behalf, they will shop on their own behalf, buy them into their inventory, and sell them at an undisclosed spread to you. It can take a substantial research effort to find out whether the spread they earned can be considered fair based on current market conditions.

To complete the "taste test," there are two indirect sources of income that are worth mentioning: "soft dollars" and "hypothecation." In a "soft-dollar" arrangement, a third-party broker that executes stock and bond trades on behalf of an asset manager or advisory firm will offer research services, data subscriptions, or even expensive Bloomberg terminals to its clients, with the understanding that a certain volume of trades will continue to flow in its direction. At a minimum, this creates the perception of conflict, with an actual conflict developing if the client firm winds up directing trades to itself that could be executed on better conditions with a different third party. At Manchester Capital, we pay for our own research and data services and never accept any "soft dollars."

"Hypothecation" of securities may be practiced in certain types of brokerage accounts. During the account opening process a client, usually unwittingly, will sign a package of documents that includes a "hypothecation agreement." This means that the broker can, with no additional notification, periodically borrow securities from the client's account and return them at a later date. These securities will be loaned to the "prime brokerage" side of the broker's business, which will, in turn, lend them to hedge funds, that can then sell them into the market as part of a legitimate "short selling" strategy. The conflict in this scenario is that the broker is earning additional fees while taking risk with securities that belong to the client. Manchester Capital selects custodian arrangements on behalf of its clients in which securities are ring-fenced and not exposed to hypothecation practices.

The primary conclusion to draw from these limited examples is that true advisors strive to align their interests with their clients in every aspect of their business practices, including their sources of income, compensation processes, and financial transparency. Financial product providers and distributors play an essential role in our industry. But it is unwise to think of them as impartial advisors, owing to the complexity and potential conflicts in their sources of income.

WHERE DO WE SEE OPPORTUNITIES?

by Morgan Roberts, *Senior Wealth Manager*

The U.S. market has appreciated significantly since the lows of the financial crisis. It hasn't been a smooth ride, though. Remember Fukushima, the BP Deepwater Horizon disaster, European Austerity, fears of a double dip, swine flu, the "flash crash," the UBS trader who lost $2.3 billion (Kweko Adoboli), and on and on. Some of our clients have expressed concerns that since there's been such a strong rally in the markets over the last six years, they must be a little rich and likely to suffer a correction. They're also hearing the constant drumbeat of negativism from bears and hedgies that missed the rally.

So, where does Manchester Capital Management see opportunities? Our clients have probably noticed from the annual report and client meetings that we've been optimistic on the emerging markets. The share of global nominal consumption for the emerging market countries has increased from 23% to 37% in the last 10 years. It could be over 50% in another 10 years. The working-age population in the developing world is 5-times larger than in developed nations and they're eager to work hard and improve their standard of living. Expected GDP growth rates and dividend yields are higher than other asset classes. Valuations, as defined by the price-to-earnings ratios, are lower than those of other asset classes.

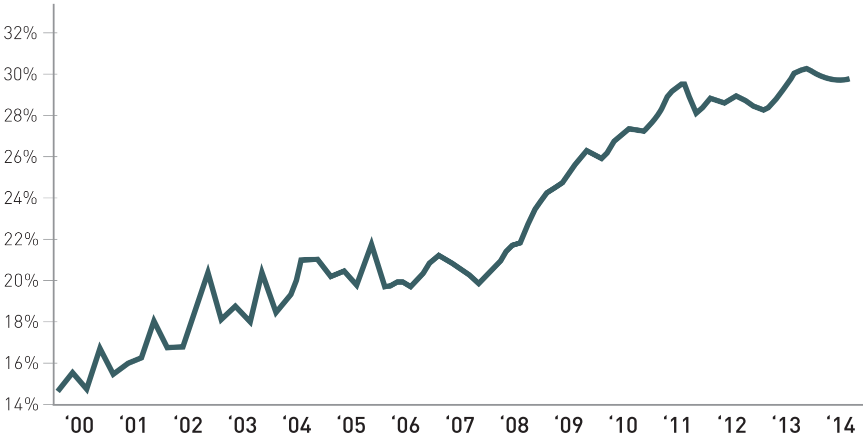
Catalysts to unlock this opportunity could be the accumulated cash hoards that U.S. corporations have overseas. Presently, corporations have a record $2.1 trillion in overseas assets, about $700 billion in the form of cash or cash equivalents. This is cash that companies have earned from foreign operations but are reluctant to bring back to the States because it would suffer U.S. corporate taxation. If U.S. companies don't repatriate this cash, they will slowly invest this money overseas in new plants, equipment, factories, and employees. Clearly, this benefits foreign economies rather than the U.S. economy.

Congress could grant a one-time tax holiday to allow U.S. companies to repatriate foreign earnings (cash) without the imposition of U.S. taxes or at a reduced tax rate. Is that likely? Not really. If the U.S. doesn't act, then it can be argued that the U.S. is essentially encouraging U.S. corporations to invest overseas.

One of the reasons why companies invest overseas is because the U.S. has one of the worst corporate tax rates in the world, at 40%. Among developed countries, only Italy has a higher corporate tax rate. Yes, the IRS allows generous deductions that

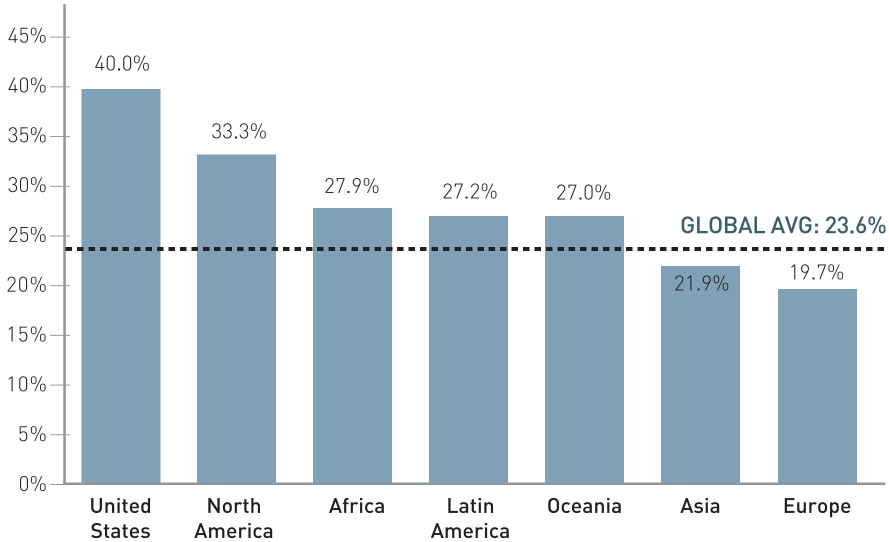
Corporate Cash as a Percentage of Current Assets

S&P 500 companies — cash and cash equivalents, quarterly



Source: Standard & Poor's, FRB, Bloomberg, Compustat, FactSet, JP. Morgan

Corporate Tax Rates Around the World



Source: JP. Morgan

can lower a company's overall taxable income, including a credit for foreign taxes. However, the overall corporate tax rate is a factor when companies choose where to build operations and domicile headquarters. People may remember when there was a big stink about General Electric paying nothing in U.S. taxes. The company argued that it was true it paid next to nothing in U.S. corporate taxes but it paid its fair share in numerous other taxes, both foreign and domestic.

Many large, multinational companies are electing to use their foreign cash reserves to repurchase their shares on the open market. This acts to take the shares out of circulation and thereby improve earnings per share numbers as well as dividend yields. It also allows companies to preserve their cash as an investment in their company (Treasury stock) and keep it for future investments or acquisitions. However, they have to repatriate the cash in order to repurchase their shares.

With any opportunity, there are risks. We are a little concerned about Chinese small caps. China's small-cap index, ChiNext, has risen nearly 100% over the last year and has a trailing price-to-earnings ratio of 90. Moreover, the bloated credit problem in China is getting worse. Margin loans on Chinese investment accounts are at a new record - 1.67 trillion yuan ($269b), up 300% from last year. Although we are monitoring our managers' exposure to small cap companies in China, we are favoring emerging and frontier markets as a whole.

INSIDE MCM

Company-wide Retreat

All Manchester Capital Management employees gathered in Santa Barbara, California, in early May for a two-day retreat to encourage team relationships, share important information about the firm's continued growth, and review the firm's business practices, culture, and values. Everyone enjoyed collaborating on ways to best serve our clients in the increasingly complex and busy world. The retreat consisted of excellent team building activities and each department sharing their accomplishments over the past two years and their initiatives looking forward.

Some Recent Firm Highlights

- Greg Dienna recently returned from Lisbon, Portugal, where he was invited to teach a class on business ethics for the CFA Institute's Standards of Professional Conduct. This was Greg's second trip to teach a class of over 30 students studying at the University Institute of Lisbon (ISCTE). The core focus of the class is how best to navigate real world ethical challenges.

- We are excited to announce we will have a new portfolio analyst starting in the next few weeks. He will be based in the Charlottesville, Virginia, office and provide support to our wealth managers.

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