The Abernathy Group II
Family Office

To Our Members of the Abernathy Group II Family Office,

Over the last few weeks, we have received a number of calls from the families we serve, asking questions about the recent market downturn and its corresponding volatility.

The focus of these calls embraced a range of questions. Some fearing the end of the world and of civilization as we know it, others wondering if this is now a buying opportunity.

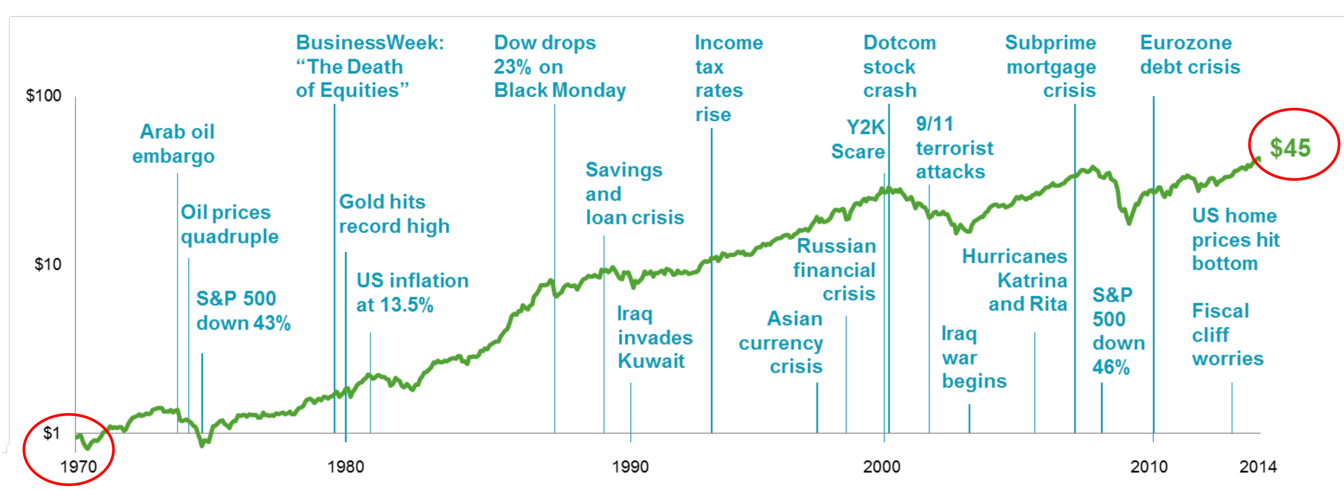
The goal of this letter is to acknowledge the fact that there are things wrong in the world, yet to address their relative importance, and remind you of our investment strategy and the importance of remaining disciplined.

Investor Discipline

History tends to repeat itself. Negative headlines and their corresponding market corrections are a normal part of capitalism, growth, and free markets. They are what Warren Buffet might call "capitalistic evolution", a natural cleansing process; one that shakes out speculators, so that intelligent investors can survive and prosper. As you can see from the chart below, a disciplined investor is rewarded for looking beyond the concerns of today to the long-term growth potential of markets.

Markets Have Rewarded Discipline

Growth of a dollar—MSCI World Index (net dividends), 1970–2014



The Wall of Worry
The most frequent question asked of us over the past month has been "what is upsetting the market"? Our answer is an ever increasing list of possible "upsets", many of which, after being publicly addressed, have been summarily dismissed or forgotten shortly thereafter, allowing new successive "upsets" to take their place. Intelligent students of the market call this series of never-ending challenges "the wall of worry" which the capital markets seem to climb each and every day.

We believe that today (August 25, 2015) the "wall of worry" is primarily comprised of the following investor concerns (some more far-fetched than others).

- Greece will default on its debt obligations, leading to a global economic downturn
- China's economic growth rate is decelerating faster than the markets realize, and will lead the world into a global recession
- As the U.S. dollar continues to strengthen, it will become increasingly difficult to sell our goods and services abroad, thus resulting in a US recession
- The U.S. has been expanding for almost 8 years now, and as the average expansion lasts 8 years, implies that we are heading for a recession any moment
- The price of oil has plummeted, indicating that the world is already in recession, and any data stating otherwise is government propaganda
- Iran is on the verge of developing a nuclear bomb, and they will unleash it on either Israel or a neighboring country, thus triggering a nuclear war
- Russia is starting its expansionary land-grab, which will lead to war between all of the world's major powers, with China likely siding with Russia
- Gold is off 40% or more from its high, thus indicating that we are in a global recession
- The whole "metals-complex" (copper, iron ore, etc.) is down 40% or more from its peak, thus implying we are in or heading towards recession
- There is so much debt in the world; we cannot possibly grow our way out of it. This over indebtedness will surely lead to a collapse of the sovereign fiat currencies, and a new world order where traditional financial assets are worthless.

Let me remind each reader that this list is by no means a comprehensive list of EVERY investor concern, rather, a highlight of those concerns we are most commonly reading about, and hearing from our clients. There are literally millions of independent agents investing in the global capital markets, and we have no way of knowing what is on everyone's mind.

It is also worth noting that there is at least a grain of truth to each concern listed above. Unfortunately, it is the extrapolation of these truths that is often misunderstood.

It seems to us that the most thoughtful way to understand how bad of a situation we are in, is to address these concerns individually, and understand the implications of each. So, to help every family we serve wade through this list of headlines, we will address each concern below by answering the following questions:

- What is wrong?
- Is it true?
- Does it matter?

I. *Greece will default on its debt obligations, leading to a global economic downturn*
   a. Greece is currently in default, and has been effectively "working out" its debt with its creditors for years. It is inevitable that further defaults and debt restructurings will follow. However, it is important to remember that Greece represents only 2% of the Eurozone's Gross Domestic Product (GDP). While it is never good to have any member of your team (the analogy is that Europe is a team of countries) fall on difficult times, losing some portion of 2% will NOT start a global downturn. Make no mistake. It is going to be difficult for Greek citizens over the next 5-10 years as they will have to start paying taxes and living within their means. The reality is that Greece's future does not really matter much to the rest of the world. When Greece finally does default on more of its debt, it will NOT pull the world into a global downturn.

II. *China's economic growth rate is decelerating faster than the market realizes, and will lead the world into a global recession*
   a. While it is true that China's economy has been slowing from 12%+ growth to 5% growth, China is a long way from entering a period of negative growth. China is attempting to turn a ship that is 5 times the size of the U.S. in terms of its citizenry and consumer population, and it is natural for the governing body to go through periods of overheated and under-heated economic growth. The investing public and the press are focusing on the wrong challenge. China is the most certain growth engine on earth over the next 50 years. Their consumers represent only **30%** of GDP. In the US, the consumer represents 70% of GDP. So a country 5X as large as the U.S. with ½ the current consumer demand is <u>explicitly</u> stating it wants be more like the developed world. If successful, China will double its consumer spending over the next several decades. Our advice is that China's economic slowdown should only matter to those intelligent investors looking for an entry point into possibly - the greatest growth story of the 21st century.

III. *As the U.S. dollar continues to strengthen, it will become increasingly difficult to sell our goods and services abroad, thus resulting in a US recession*
   a. The recent strengthening of the US dollar has raised concerns, as our currency has appreciated 12% over the past year, rising against almost all of our trading partners. This strength, however, is not a negative. Exporters represent less than 5% of our GDP. And a 10% appreciation in our currency merely shaves 0.5% off of our GDP growth over a one year period. Therefore, while US exporters will be hurt by a strengthening dollar the impact on the US economy will not be meaningful. In fact, 95% of the US economy is positively affected by a strengthening US dollar, as US consumers, importers, and companies can purchase foreign products at lower prices.

IV. *The U.S. has been expanding for almost 8 years now, and as the average expansion lasts 8 years, implies that we are heading for a recession any moment*
   a. While it is true that the average expansion lasts approximately 8 years, the standard deviation around that number is significant *and* important. The shortest period of expansion was 24 months and longest was 120 months. What is more important to understand is that all US recessions have been preceded by either accelerating inflation or substantial central bank tightening, neither of which are occurring today. In fact, we are in a period of global deflation at the moment, and we are just starting to even consider raising interest rates. Therefore, while the average expansion is approximately 8 years, there are several to many other variables to consider before calling for the U.S. to enter a recession.

V. *The price of oil has plummeted, indicating that the world is already in recession, and any data stating otherwise is government propaganda*

a. The price of oil has fallen by over 50%. This has been driven by more of a supply problem, then a demand problem. US production has nearly doubled over the past 6 years, and the U.S. is now the largest producer of oil on earth. While lower energy prices create a headache for companies involved in isolating, producing, and selling energy, lower energy prices are great for every country that imports energy. It is also great for every company that uses energy to manufacture goods and services, and for every consumer who uses energy in his or her day-to-day travails. Therefore, while the headlines may be attention grabbing, the downturn in energy prices will actually be a positive for our global economy.

VI. *Iran is on the verge of developing a nuclear bomb, and they will unleash it on either Israel or a neighboring country, thus triggering a nuclear war*

a. Iran is years away from being able to create a nuclear bomb. While we are not discounting its significance, this is not worth spending much time on in our estimation. Our government and most of the global powers are very interested in ensuring Iran, does not have access to a nuclear armament.

VII. *Russia is starting its expansionary land-grab, which will lead to war between all of the world's major powers, with China likely siding with Russia*

a. While Russia does appear to be implementing an expansionary policy, it is worth remembering that Eurasian borders are constantly changing. More importantly, this type of geopolitical analysis is unlikely to impact globally diversified investors that have a long-term investment horizon. For those concerned about this specific issue, it is worth noting that Russia is experiencing a severe recession, as a plunge in oil prices continues to devalue their currency (ruble), further reducing their likelihood of financing a military confrontation.

VIII. *Gold is off 40% or more from its high, thus indicating that we are in a global recession*

a. Gold's depreciation has been a function of lack of investor demand, and the strengthening dollar. As a dollar denominated instrument, when the U.S. dollar rises in value, the price of gold falls. Gold is a non-productive asset, meaning its demand is largely a function of investor sentiment as an alternative store of value. So when the demand for gold falls, it implies that investors are not concerned about the markets.

IX. *The whole "metals-complex" (copper, iron ore, etc.) is down 40% or more from its peak, thus implying we are in, or heading towards recession*

a. The metals complex is often a bellwether of global construction demand. Unfortunately, the decelerating growth in the Chinese real estate market that has been corresponding to the deceleration in the growth of their economy from 12%/year to 6%/year, has driven down the price of the underlying metals commodities. Further exacerbating this downtrend is the fact that miners have had access to low interest capital for the better part of the last 8 years, and have used this cheap debt financing to build new mines, and buy new equipment. As a result, a significant amount of capacity has come on line just as China started to slow, and just as the U.S. dollar started to *appreciate* against many of the world's currencies. A decrease in commodity pricing represents a perfect storm for commodities producers – and a wonderful occurrence for anyone and everyone who uses these commodities to build and grow. We believe this is a lagging indicator, not a predictive indicator of global growth.

X. *There is so much debt globally, we cannot possibly grow our way out of it. This over indebtedness will surely lead to a collapse of the sovereign fiat currencies, and a new world order where traditional financial assets are worthless.*

a. There are many ways to cure any single country's indebtedness. Countries can inflate their way out of their debts, they can default on their debt, or they can restructure their debt by continuously extending their maturity and lowering their interest payments. This is not to say everyone is happy about this. When a country inflates their way out of debt, the citizens of the country and those with savings suffer. When a country defaults, those owed the debt experience a total or partial loss. When countries refinance and extend their debt, those who are owed the debt are unlikely to receive their principal until years beyond their original expectations, and often receive lower interest rates during that time. Moreover, if none of the above works, historically, war has been an alternative.
   The point is that money has been borrowed and repaid, or not, for centuries. For as long as the notion of a negotiable currency exists, there have been winners and losers. The U.S. is THE world's currency. This gives the U.S. much more latitude and so many more options than almost any of the other currencies in the world. We agree this is a challenge for the U.S. (and should include Japan, Europe and many other indebted countries in the "challenged" list). It is important to note that this situation can go on for decades without eventually being solved. During the course of this time, laws can be changed, and taxes increased/decreased, each of which can either improve or make more difficult the ability of the entity to pay back its debt. The bottom line is that this is not something to worry about over the coming decade.

The point of this exercise is to remind every investor that a list of challenges will always exist. Challenges will rotate and often change. Sometimes these challenges are real and truly matter. But most of the time they are not true, or simply do not matter. The one constant is that there will always be a "wall of worry".

Your challenge as an investor is to understand that 99.9% of the time all of these "wrongs" or potential "upsets" are already priced into the capital markets. By the time you have read it in the paper or heard it on television, so have hundreds of millions of other investors. They are not dummies and are probably just as smart as you are.

Our Investment Strategies

Our actively managed investment strategy strives to buy assets at a discount to their intrinsic value, understand why those assets are selling for less than other identical or similar assets, and identify what changes must occur to provide us with a clear pathway to improving those asset values, thus creating shareholder wealth. If everything is in place, we then assess our probability of achieving these changes. If the probability of success outweighs the risks, we make the investment. If the probability of success does not outweigh the risk, we stop, put it back on the shelf, and re-evaluate later. When buying undervalued assets, with a clear pathway to value creation, and a high probability of success, emotion is our enemy, and time is our friend.

Our strategy for high net worth families focused more on capital preservation and investments which outpace inflation, is to own a globally-diversified group of equities and a globally-diversified group of interest bearing investments representing the *global* financial markets. This evidenced-based approach has tended to appreciate at a rate greatly exceeding inflation over the last 100+ years. We strongly believe it will do so over the next 100 years, as we believe that *capitalism provides the framework for value creation*.

Conclusion

For those of you who are using The Abernathy Group II Family Office for advisory services, please realize that while we are optimistic about the future, we work hard to seek and collect data which challenges our views as much as we embrace data that agrees with our views. We strive to see both sides of the coin, and take pride when referring to ourselves as Rational Optimists.

As we discussed earlier, there are always macroeconomic risks, or "upsets", manifesting themselves in the marketplace. A few of these negative outcomes will come to fruition and set us back, while most others will quickly fade from memory.

We cannot tell you where the capital markets will be in 2 days or in 2 months. However, we strongly suggest that in 2 years, intelligent investors will be happy they ignored the headlines and the frantic remonstrations from the press. Those intelligent investors will be both ahead of the game and glad they spent their time with the families they love or involved in things they are proud of.

Our goal is to help you use your family's assets as a tool, and provide your family with the outcomes you desire. These outcomes may be a certain lifestyle, a certain philanthropic goal, or a personal family objective. We will strive to keep your actions focused on your family's personal outcomes, and not on the day-to-day movements of the stock market.

As always, we invite questions and comments. Please call us if you have either. We will be glad to discuss both.

Sincerely,

Steven Abernathy
Chairman
The Abernathy Group II
Family Office

Brian Luster
Chief Executive Officer
The Abernathy Group II
Family Office