Torii® Asset Management

"Dedicated to the pursuit of elite investing"

October 9, 2015

During the third quarter the NASDAQ, Russell 2000 Growth, and S&P 500 indices were down 7.4%, 13.2% and 6.9% respectively while the iShares Barclays 7-10 yr. Treasury Bond ETF (IEF) gained 2.7%. As previously stated, commodities were weaker with energy being hit especially hard. West Texas Intermediate (WTI), the domestic benchmark, fell 24%.

The third quarter was a scary time for investors as the market experienced the first 10% correction since the summer of 2011. There was continued talk of a slowdown in China. Saudi Arabia, which I mentioned in my mid-quarter market commentary, reportedly liquidated $60-$70 billion in global assets to stabilize their growing budget deficit due to lower oil revenues. Also, Glencore which has one of the largest commodities trading desks in the world reportedly came under financial pressure. Glencore is important due to their size of leveraged positions since they in effect "insure" their financial positions with credit default swaps (CDS). This "insurance" involves large counter-party risk with the investors being able to perform on the CDS's in case of a default by Glencore.

During the third quarter, commodities were hit due to the U.S. Dollar strengthening against a basket of 16 widely traded currencies. A stronger dollar tends to depress commodities priced in the greenback as they become more expensive for other currency holders. As the Dollar was purchased, so were U.S. Treasuries which sent the 10 year Treasury to a paltry 1.99% yield on October 2nd.

All of the factors mentioned above have been singular adjustments rather than a systemic breakdown to the financial system as in the 2008-9 meltdown.

The world is full of misinformation. Past predictions which never materialized into a financial meltdown include:

1. Fallout from a "Grexit" if Greece leaves the European Union.
2. "Eurogeddon" or the collapse of Europe around 2012 from fallout of the PIGS (Portugal, Italy, Greece, and Spain).
3. In early 2012 some oil analysts predicting Brent crude could reach $200 a barrel. Today it is at $48 a barrel.

4. May 2009, Marc Farber, Ph.D. in Economics claimed "I am 100 percent sure the U.S. will go into hyperinflation." A few years later he doubled down, stating that the U.S. would experience Zimbabwe-like hyperinflation.
5. In early October 2008 after the stock market dropped almost 50%, CNBC personality and former hedge fund manager, Jim Cramer, advised, "whatever money you need for the next five years, please take it out of the stock market." The market bottomed 3 months later and was up over 100% five years later.
6. Contagion from the avian flu and Ebola.

Let's focus on what we know:

1. Even though an interest rate increase is on the horizon it is and will most likely remain historically low.
2. The U.S. economy continues to expand rather than contract with payrolls increasing.
3. U.S. housing, according to the most recent HUD release in August states "House prices continue upward trend in June and year-over-year house price changes have settled into a 4- to 5-percent pace" and "Sales of previously owned (existing) homes rose for a third straight month in July." This is important since home purchases are accompanied by purchases of large durable good items.
4. We have an upward sloping interest rate curve which indicates the credit market participants are not positioning for a recession.
5. The slower growth rate of China continues to dwell on the markets even though it represents only 0.7% of U.S. GDP. Of course it matters, but not to the extent that it has been overblown. It continues to be monitored closely for material changes and contagion effects. China's slowdown is more of a challenge for neighboring emerging economies and Australia and Canada due to their significant natural resource exports.
6. Due to the Asian slowdown, the International Monetary Fund (IMF) has trimmed its expected global growth forecasts for 2015 to 3.1%. In its report published Tuesday, the organization said that global growth "remained uneven" with developed economies and emerging markets facing diverging outlooks.

Nobody likes seeing a loss during a correction but there are opportunities that develop. Looking ahead to the fourth quarter, I believe active portfolio managers investing away from the large indexes laden with multi-national companies will have the best opportunities. Small domestic companies should continue to grow in the current economic environment and be largely insulated from the China slowdown contagion.

A couple examples of growing companies that look attractive and shouldn't experience pressures from slower global growth expectations are Energy Focus, Inc. and Azure Midstream Partners, LP. They have been temporarily caught up in the recent correction but should recover as their businesses grow.

One of Energy Focus's products is the military tough LED Intellitube, a replacement for fluorescent light. They are the sole LED retrofit provider of products to the U.S. Navy since 2007 and continue the conversion which is a little more than half completed. Due to the U.S. Navy's stringent requirements and specifications their lighting products are now being sought & purchased by foreign Navies who have also begun conversion of their fleets to LED. Other than their military involvement, Energy Focus has begun the initial phase to retrofit Cleveland Clinics main campus. It is expected to require approximately 250,000 TLEDs and take 18 to 24 months to complete.

Azure Midstream Partners, LP. is another domestic company and provides natural gas gathering, transportation, treating and processing services and NGL transportation services.

Throughout the year, Azure management has completed a restructuring and is estimated to show dramatic earnings growth coupled with an attractive dividend payout.

As mentioned last quarter I will be interested in released information as the IMF concludes its quinquennial Special Drawing Rights (SDR) review as to whether China receives approval to have the Yuan (¥) added to the basket. Depending on currency positioning, an outcome may have far-reaching implications as currency and assets of major institutions are reallocated.

With a large interest rate increase being kept at bay, and as the economy continues to grow, the stock market continues to look attractive for growth investors. If overall earnings are muted and the stock market falls dramatically, it would be an attractive opportunity if there are no other material developments.

To our existing clients, I extend my sincere thanks for your business. You have our continued commitment to your success. To prospective clients, I invite you to come and grow with us.

As always, Torii Asset Management strives to provide the best service possible to you, our client.

Very truly yours,

Martin L. Yokosawa

Torii® Asset Management *Torii® Investments*

9S040 Stearman Drive, Naperville, IL. 60564 (630) 420-0221

yokosawa@toriiassetmanagement.com