SELECTIVE
WEALTH MANAGEMENT

Annual Report 2013

Authored By:

Christopher J. Devlin – *Portfolio Manager*

Each account experienced different returns due to differences in account size and the inception date. We have taken some time to explain these differences in great detail on pages 22 and 23.

We encourage all of you to read them.

For additional information email: info@selectivewm.com

Executive Summary

Year	Selective	S&P 500[2]	Relative	
2009	+86.0%	+60.1%	+25.9%	Accomplished at previous investment partnership.
2010	+23.3%	(4.5%)	+27.8%	
2013[1]	+39.2%	+24.2%	+15.0%	
Cumulative	+220.3%	+89.9%	+130.4%	

Table 1: Businesses Sold During 2013

Business	Symbol	Purchase Price	Sale Price	Gain (Loss)
BofI Holding Inc	BOFI	$35.39	$68.89	94.66%
Infosys Ltd ADR	INFY	$40.07	$51.03	27.35%
Global Payments Inc.	GPN	$44.74	$56.94	27.27%
Coach Inc.	COH	$47.55	$59.15	24.40%
Apple Inc.	AAPL	$417.26	$513.02	22.95%
Oracle Corporation	ORCL	$30.26	$36.34	20.09%
National Beverage Corporation	FIZZ	$13.47	$15.60	15.81%
Cisco Systems Inc	CSCO	$20.80	$24.03	15.53%
Royal Dutch Shell PLC ADR Class B	RDS.B	$65.50	$71.76	9.56%
Royal Dutch Shell PLC ADR Class B	RDS.B	$65.86	$71.50	8.56%
Joy Global Inc.	JOY	$53.87	$50.25	(-6.72%)

Table 2: Businesses Presently Owned

Business	Symbol	Purchase Price	Current Price[3]	Gain (Loss)
Higher One Holdings Inc.	ONE	$7.10	$9.76	37.46%
SolarWinds Inc.	SWI	$32.78	$37.83	15.41%
Cisco Systems Inc.	CSCO	$21.08	$22.43	6.40%
International Business Machines	IBM	$183.85	$187.57	2.02%
National Interstate Corp	NATL	$24.62	$23.00	(-6.58%)

1) Returns are from inception (March 1st) to year-end. Returns for partial years are not annualized.
2) S&P 500 returns are total returns - which include price changes and dividends. The S&P 500 is not a suitable benchmark and is used for general comparison. We do not believe there is a suitable benchmark given the concentrated nature of our investment style.
3) Additional information is available upon request – info@selectivewm.com

Results

Our returns were very strong in 2013 on an absolute and relative basis. The markets in 2013 had an incredible year and we are delighted to say we outperformed the bull market by a very wide margin. Our objective is to outperform the market by 10 percent in any given year and 2013 was satisfactory in that regard with relative performance of +15.4%. We will be aiming for similar relative performance in 2014, but suspect that the absolute performance will not be matched.

Year	Selective	S&P 500[2]	Relative
2013[1]	+39.23%	+24.18%	+15.05%

A Little On Risk

As a firm we outperformed the market by a very wide margin this year. This level of performance is typically attributed to one of two factors: getting lucky or taking more risk. As for the former the passage of time will reveal the veracity of that assertion – my focus this year is to address the latter.

Our investment style is to concentrate our investments heavily on a few strong positions and for this reason we are required to label our investment style as “High Risk, High Return”. We do not believe that achieving high returns requires taking on high risk. In fact, we have an extreme disdain for taking risk and make every effort to protect our client’s assets. Our primary strategy for protecting principle is to purchase only the most impressive businesses in the world. Let’s evaluate the ‘risk’ we assumed while generating superior returns in 2013 by looking at the *businesses* we purchased.

In total we purchased 14 different businesses that have reported a total of 136 fiscal years of operating results over the course of the last decade (SolarWinds and Higher One went public during that time period). Of those 136 annual reporting periods the businesses we purchased posted 136 consecutive profitable years. It would be hard to imagine a safer investment and it is evident that this level of sustained performance from the businesses we owned was not attributed to luck. As a firm we do not purchase turnaround situations, do not rely on activist investing, do not participate in risk arbitrage, do not purchase start-ups, and avoid complex situations like the plague. We do not rely on luck or take high risk. We simply buy impressive businesses at brilliant prices.

Reporting profits is a desirable characteristic of any business we own, but reporting *increasing* profits year-over-year is even more desirable. The businesses we purchased posted year-over-year *increases* in profits 109 out of 122 annual reporting periods during the past decade. This stellar record includes the abysmal years of 2008 & 2009 in which nearly all enterprises reported year-over-year declines in profits.

The businesses we bought this year not only consistently posted increasing profits, but they did so with bullet-proof balance sheets. Excluding the bank and insurance companies, we purchased twelve operating businesses this year. Four of the twelve businesses we purchased had very low levels of debt with operating incomes exceeding their interest payments 35 to 1, 50 to 1, 50 to 1, and 70 to 1, respectively. The remaining 8 businesses had net debt positions of *zero.*

In addition to operating with almost no debt the businesses we purchased this year also have demonstrated exceptionally high returns on capital. They had returns on equity ranging from 16% to 90% with an average return of 38%.

The level of quality we demand in a business before we will even consider it as an investment option should speak volumes about the amount of risk we are willing to assume. Now for the companies themselves…

Businesses Sold During 2013

Below you'll find a table that includes each business we held, how much we paid, how much we sold it for, and the gain or loss associated with that investment. The table is sorted in descending order from our best performers to the worst. We've also included a synopsis of each investment that describes why we made the purchase and why we eventually sold. By understanding why we purchased these businesses you'll be able to understand our investment philosophy on a deeper level.

Table 1: Businesses Sold During 2013

Business	Symbol	Purchase Price	Sale Price	Gain (Loss)
BofI Holding Inc	BOFI	$35.39	$68.89	94.66%
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Joy Global Inc.	JOY	$53.87	$50.25	(-6.72%)

BofI Holding Inc.

Ticker: BOFI
Purchase Year: 2013, Sale Year: 2013
Purchase Price: $35.39, Sale Price: $68.89
Gain: +94.66%

Purchase Decision – BofI Holding Inc. is the parent company of Bank of Internet USA. Historically the best banks were those that earned the largest spread on their assets – they paid very little interest on their deposit accounts and charged higher interest on the loans they made. Today there is a new breed of bank that is competing differently – the online banks. Online banks have a very substantial cost advantage compared to their brick and mortar peers and they are able to pass these savings on to their customers by paying higher rates on their deposits. This is very difficult for brick-and-mortar banks to compete against.

The primary disadvantage of online banks is that their deposit base is mostly 'brokered deposits'. Brokered deposits represent a collection of individual investors that pay a broker to find high yielding deposits. The trusted broker then shops around for the highest interest rate. The disadvantage of this type of deposit for a bank is that broker deposits are very competitive and flow in and out of banks quickly. A broker may select your bank to hold his clients deposits one year…and then the following year find a better rate and move the assets. For this reason online banks typically have very fluid deposit bases that are not as reliable as brick-and-mortar banks.

BofI has been aggressively improving their deposit base by increasing their non-brokered deposits. They recently started opening checking accounts with very attractive rates for businesses – our firm currently banks with them for this reason. They also partnered with Costco to get more retail clients and less brokered clients. Their retail client base has increased substantially to more than 40,000 customers.

BofI is also the second most efficient bank in the nation. They spend only 40¢ on expenses for every $1 of revenue. A bank typically spends 65¢ to 70¢ for $1 in revenue. Their improving deposit base and amazing efficiency has helped them achieve more than 15% returns on equity and compound earnings at more than 30% per year for a decade. In addition to world class efficiency and an improving deposits base they also are one of the most prudent banks in the nation when it comes to making loans. They coasted through the financial crisis with their loan portfolio performing extremely well. This is due to the strict underwriting performed on each loan. Simply put, when they make a loan they ensure their clients are capable and willing to pay them back.

When we purchased BofI we paid roughly 10 times their forward looking earnings – a very attractive price for such an outstanding business.

Sell Decision – Selling BofI was one of the most difficult decisions we made this year. It crossed our minds to never sell, but the drastic increase in price was too tempting. The offer we received to sell the business was nearly double our entry price and was definitely a fair value. Banking institutions by nature have substantial debt and this contributed to our decision to sell. We love businesses with little or no debt, but make exceptions for incredible banks and insurance companies. After BofI nearly doubled in value it became roughly 20% of our total assets and we were not comfortable holding a highly leveraged institution at such a high price – even a business as well run as BofI.

Since the price increased to 20 times earnings we felt that the downside risk outweighed the potential upside and we sold the business.

Infosys Ltd ADR

Ticker: INFY
Purchase Year: 2013, Sale Year: 2013
Purchase Price: $40.07, Sale Price: $51.03
Gain: +27.35%

Purchase Decision – Infosys is an IT firm located in India. The firm employs more than 150,000 people and is the center of some of the brightest minds in the world. Fun fact: 9 out of 100 applicants get into Harvard…1 out of 100 get into Infosys. The service Infosys provides is software programing. Clients approach them with processes that need to be improved or streamlined and Infosys partners with those clients to develop software solutions that eliminate hundreds of thousands of man-hours of labor. Every dollar spent developing solutions saves their client's enormous sums. Infosys is helping mankind accomplish more with less – all through the power of software. This type of software development is extremely important for our global economy and will expand indefinitely.

The economics of a single client relationship are amazing. When Infosys partners with a client they develop a very intimate relationship and tend to monopolize all work with that client going forward. In 2012 they had 798 clients and received 98% of all their revenue from repeat business. It is one of the 'stickiest' business models in the world and makes predicting their income relatively simple. Infosys has been able to compound their earnings every single year at an impressive rate for more than 25 years by simply adding a few new customers each year. They've accomplished this feat with zero debt.

We purchased Infosys at roughly 12.5 times earnings. The business was fairly mature and we didn't expect much growth, but this was a very attractive price for a business with no debt and an incredible competitive position.

Sell Decision – We ended up selling the business in a relatively short time frame due to the increase in price. We still very much love the economics of the business, but due to its maturity we were content to liquidate the position at the price that was offered. We expect Infosys to continue to grow at a reasonable rate, say 2% - 8% for the next 10 years, and given these expectations a 27% price increase was sufficient to sell. In our view we purchased Infosys at a value of $0.80 on the dollar and when offered the opportunity to sell at $1.00 we jumped at the chance.

Global Payments Inc.

Ticker: GPN
Purchase Year: 2013, Sale Year: 2013
Purchase Price: $44.74, Sale Price: $56.94
Gain: +27.27%

Purchase Decision – Global Payments is a 'merchant acquirer' and provides services to make electronic transactions possible. They install terminals where you swipe your debit or credit card and then they route the card, bank, and transaction information to the Visa or MasterCard network […simplified, but you get the idea]. They generate revenue as a percentage of each transaction processed at their terminals.

The predictability of Global Payments income is extremely high. They have more than 1,000,000 business locations signed into three year contracts with client retention rates in mid-80% range. The highly fractured customer base, high renewal rate, and three year contract terms make their income extremely predictable and near certain. They had one particular event and some complexities in their accounting that we believed helped us purchase the business at an attractive price. We'll start with the event…

In early March of 2012 they had a security breach that cost the firm more than $120 million to remedy – a very high percentage of their income. This security breach was self-reported, which is very important for the integrity of the business, and actions were taken to correct the issue. The majority of the costs associated with this breach were one time in nature, but they also needed to increase how much they spent annually securing their card information. This annual increase scared investors…and scared them way too much. We purchased Global Payments when it was relatively easy to calculate their new 'normal' earnings. Now for the accounting…

Global Payments tends to report lower earnings than economic reality. This is due to the nature of their amortization expense. They tend to overstate the amortization cost of acquired customer relationships due to a difference between the stated useful life of an acquired customer relationship and the actual useful life. They've been able to spend more than their stated income on acquisitions, dividends, and share buybacks due to this overstatement of expense. It should be noted that this accounting irregularity is defined and enforced by GAAP and they should continue to report this way in the future.

After adjusting for the security breach and amortization expenses we purchased Global Payments at roughly 11 times earnings.

Sell Decision – We sold Global Payments due to the rise in price. One of the primary factors that kept us from demanding a higher price for the business was their distribution model. They derive a lot their sales internationally through their direct sales force, which we love, but then domestically they use Independent Sales Organizations (or ISOs). The drawback of signing up new merchants through ISOs is the retention rate is less and the prices more competitive. The retention rate for a merchant customer signed up through ISOs is roughly 70% compared to the high 80% for a customer signed up directly. If Global Payments had a stronger direct sales force we likely would have held on to the business and expected a higher price before selling.

Coach Inc.

Ticker: COH
Purchase Year: 2013, Sale Year: 2013
Purchase Price: $47.55, Sale Price: $59.15
Gain: +24.40%

Purchase Decision – We sold Coach Inc. for a +24.40% gain. Coach Inc. is a maker of luxury hand bags. I've been a fan of their business for quite some time…although never a customer. Their handbags cost roughly $30 to make and $300 to purchase. This equates to a gross margin of 90%. Love it.

Coach has an iconic brand that has been cultivated by the genius of Lew Frankfort and Reed Krakoff. We've been impressed with the duo since the company was first spun-off from Sara Lee. Lew has been tenacious to never offer discounts on their products in order to maintain the image of the brand. This is the type of mentality you must possess as the CEO of a luxury goods company.

The balance sheet for Coach is unique compared to many of its peers in the retail space. They have no debt, but do lease their store space. These lease payments function much the same way as a debt payment, but Coach maintains a cash balance sufficient to pay more than 3 years of rent with no further sales. Their cash flow is also very unique for a retailer. If you stroll through an average mall, the stores you see typically earn between $2 to $4 in operating profit for every $1 in lease expenses. This would include Aeropostle, Abercrombie, Victoria's Secret, The GAP, etc. When times get rough you'll see some of these stores close because they can no long cover their lease expense. If things get really bad the entire business could go belly up. Coach is a fortress of financial stability generating more than $6 in operating profit per $1 in lease expenses. Combining this strong cash flow with their massive cash pile puts Coach in a league of their own when it comes to balance sheet safety.

We purchased Coach after they released poor quarterly results in March and investors were fearful of the rising star, Michael Kors. The stock fell almost 20% and we scooped it up. The primary reason we made the purchase is that Coach's customers are fiercely loyal. They make routine repeat purchases and Coach intentionally cultivates this relationship to keep them engaged.

This loyalty, although primary, wasn't the only factor in our purchase decision. We were also intrigued by Coach's ability to expand their operations into China. They have been opening stores there at a dizzying rate and it is widely known that the middle class in China loves luxury goods. The Coach brand is taking off, same store sales are increasing, and we believe in five years this market will be very lucrative for the company.

We purchased Coach at roughly 13 times earnings after the precipitous fall.

Sell Decision – This was one of the few sales that occurred due to changes in price *and* changes at the company. It was announced that Lew Frankort and Reed Krakoff would be leaving the firm in February 2014. The effect would be similar to Tom Brady and Bill Belichick announcing their retirement from the Patriots at the same time. And to make things worse Lew and Reed are going to start their own company. We decided it would be wise not to compete against these two: after all, we bought the business because we wanted them on our team. After a rise of +24.40% and the announcement of the superstars departing we decided to exit stage left.

Apple Inc.

Ticker: AAPL
Purchase Year: 2013, Sale Year: 2013
Purchase Price: $417.26, Sale Price: $513.02
Gain: +22.95%

Purchase Decision – Apple Inc. needs no introduction. They sell iPads, iPhones, Mac Books, and iPods and their customers include…everyone on the planet. When we made our purchase it was a highly controversial time and we ignored all analyst reports and news articles about the future prospects of the company. This company is dominant and makes a lot of money. Let us explain why we made the purchase.

Apple and Google have an effective duopoly on the mobile device market because of their mobile operating systems, iOS and Android. People buy mobile devices for the myriad of apps and trying to sell a mobile device with no apps is nearly impossible. There is a nasty catch 22 in the world of software development that creates very strong barriers of entry - *developers do not make apps for devices that don't have market share and devices can't get market share if they don't have apps*. If you think it's easy to take market share from the Apple or Google operating systems I'd recommend asking Microsoft or Blackberry what they think (you'll have to ask Blackberry soon though, before they declare bankruptcy or are bought out).

Now, let's run through the numbers on why we made the purchase:

1) Apple Inc. was selling for $400 billion when we made our purchase and had $150 billion in cash. Roughly $100 billion of this was available to pay out to shareholders - meaning the business was selling for $300 billion when we purchased our stake.
2) Apple will earn more than $25 billion per year for the next decade. They earned $41 billion in 2012 so this seems conservative, but a calculation is still in order. Here are the following facts / assumptions that go into calculating the $25 billion dollar floor on income:
    a. They have 500 million devices 'installed' worldwide and the number is increasing daily. This means that people currently own and are actively using 500 million Apple devices.
    b. More than 90% of all Mac owners repurchase a Mac product when it breaks or it's time to upgrade. This high retention rate is typical of software products that have a learning curve because people don't like learning new things. The same is true even for the highly intuitive smart phones with lower learning curves. Our previously described catch 22 with App development also keeps competition away.
    c. iPhones last 4 years, iPads last 6 years, Mac Books last 8 years, and iPods don't matter.

    We took the above replacement assumptions and applied them to the install base for each product category. We decreased the sales price of each product category each year going forward due to pricing pressure which reduced their gross margins. This calculation yielded earnings in excess of $25 billion per year simply on *replacements*.

We effectively paid 12 times the replacement cycle earnings for the business. The reality is that Apple is continuing to add millions of customers annually - so the $25 billion per year is *very* conservative. This represents a solid investment.

Sell Decision – We sold Apple because the price increased 22.95%. This may seem odd given it only rose 22.95%, but there were two reasons why this was sufficient.

1) We made our purchase based solely on the replacement cycle of existing products. Using our base income of $25 billion the 22.95% rise was sufficient to justify the sale. We did not intend on speculating about future product categories or new technologies. Speculating is not investing. We do, however, continue to hope they release some more game changing products…but that hope is now as a consumer and not an owner. Perhaps, price permitting; we can own this wonderful business again someday.
2) The 22.95% rise in market capitalization created a 30% rise in the price of the operating business. The large difference between the change in market capitalization and the change in the price of the operating business arises from the mathematical leverage (as oppose to fiscal leverage) that is created by Apple's massive cash pile. Consider the following: Apple was selling for $400 billion with $100 billion in cash for a net purchase price of $300 billion for the operating business when we made our purchase. The market capitalization of Apple increased to $492 billion - meaning the operating business was now selling for $392 billion [$492 billion - $100 billion cash]. The 22.95% rise in market capitalization lead to a 30.6% rise in price of the operating business. A $300 billion price for a business that would easily earn $25 billion was attractive to us…paying $392 billion for a business that would easily earn $25 billion was less attractive.

I'll digress for a moment to explain how cash piles create a disconnect between changes in market capitalization and the price paid for the operating business.

Imagine that you purchase stock in a company that is earning $1 million per year and has $10 million in cash. Assume that the market capitalization when you make the purchase is $15 million dollars. The effective purchase price for operating business is $5 million ($15 million - $10 million cash). If the market capitalization increases 33% to $20 million dollars then the price of the operating business has doubled to $10 million ($20 million - $10 million cash). The larger the ratio of cash to market capitalization the more sensitive the operating business is to small percentage changes in market capitalization. This effectively makes it more difficult to experience very large gains by purchasing businesses that have a lot of cash. However, the inverse is also true - it makes it very difficult to experience large losses.

In our previous example if the business completely failed the operating portion would be worth $0, but there is still the $10 million in cash. Assuming that you have rational market participants, the market capitalization for $10 million in cash would be $10 million. Therefore, a 100% loss in the operating business would only lead to a 33% decrease in the market capitalization.

When we purchased Apple the investment characteristics were very similar to this hypothetical example. Their massive cash pile combined with a low price created a high probability of a decent upside with almost zero possibility of permanent loss.

Oracle Corporation

Ticker: ORCL
Purchase Year: 2013, Sale Year: 2013
Purchase Price: $30.26, Sale Price: $36.34
Gain: +20.09%

Purchase Decision – Oracle Corporation is one of the world's largest software companies. They create software solutions for enterprise businesses with more than 390,000 customers – including all 100 of the Fortune 100 companies. Of all the businesses we purchased this year Oracle had the safest and strongest income stream. Their enterprise software is deeply ingrained in the business processes of their clients and it becomes nearly impossible to switch once implemented. They have retention rates that are nearly 100%. The software is licensed on an annual basis and becomes part of their recurring revenue and the gross margins are in the high 90% for these license renewals.

We purchased Oracle after a 10% drop in price following a 'poor' earnings results. They posted record revenues, record profits, and repurchased a lot of their shares, but the market capitalization dropped. The logic behind this from the perspective of a professional analyst was that the expected growth rate was not met during a 3 month period. This did not concern us in the slightest. A company as large as Oracle is very difficult to grow quickly and extrapolating results from a single quarter, or even a single year, is likely a bad idea. We anticipate growth between 2% to 6% for the next 10 years. Some years will be 0%, some 2%, some 8% and perhaps even a 10% year, but in general they'll grow very gradually.

We were very delighted to purchase Oracle at $30.26 and had expectations of being able to sell the business for a modest gain in the future.

Sell Decision – We sold Oracle strictly based on an increase in price. The 20% increase in price occurred because 6 months following our purchase Oracle's growth increased by a percentage or two and analysts revised their forecasts upward. The actual value of Oracle increased roughly 3% during 2013, but we were able to take advantage of some irrational pessimism and the subsequent return to rationality. Picking up small gains like this is something we intend to do regularly with businesses that have extremely predictable income.

National Beverage Corporation

Ticker: FIZZ
Purchase Year: 2013, Sale Year: 2013
Purchase Price: $13.47, Sale Price: $15.60
Gain: +15.81%

Purchase Decision – National Beverage Corporation sells carbonated soft drinks that compete against Coca-Cola and Pepsi. They differentiate their product in two ways: 1) They have a lower price point, and 2) They target small retailers. Their very large network of small retailers was built over more than 28 years. The advantage of targeting small retailers is that they are generally less competitive and more difficult to reach than large box stores. In order to establish a relationship with a small retail location, like a mom & pop store or gas station, you need to send a sales rep to their location and convince them to purchase your products. A strong customer base is built one store at a time. It is a very difficult way to grow a business, but it has the advantage of being extremely stable because of the fractured customer base. These small stores typically stay customers for a very long time. This brings tremendous stability to their income.

We purchased National Beverage Corporation at a 52-week low and 14 times earnings. This was a very reasonable price for such a safe business. Their return on equity was extremely high and their sales team constantly added new customers every year to gradually grow their income. The best aspect of National Beverage Corporation was that they paid out roughly 100% of their income to shareholders. This is an unusually high payout ratio. They typically paid their dividend from earnings that built up over time in a single payout – known as a special dividend. These special dividends occurred every few years and totaled 100% of the accumulated income during that time period. We were delighted to make this investment in a company with extremely low debt that had a 7% annual dividend yield.

Sell Decision – We purchased National Beverage because we believed their 7% dividend yield was superior to cash and we were very content to sell for a 15.8% gain after holding the business for only a few months. This price increase equated to two full years of dividend payouts and we sold to protect these gains. It would not surprise us if in the future we had a chance to repurchase our position at our original purchase price.

Cisco Systems Inc.

Ticker: CSCO
Purchase Year: 2013, Sale Year: 2013
Purchase Price: $20.80, Sale Price: $24.03
Gain: +15.53%

Purchase Decision – Cisco Systems Inc. sells networking products and services. Their equipment directs the flow of information across companies and around the world. The network for any institution is extremely important and their decision makers have consistently demonstrated that they are willing to pay a premium to ensure their network is running smoothly.

There is a lot of talk about how selling network products is a dangerous business that evolves rapidly. We disagree with this assessment. Several technologies have been released since the advent of the internet, but the company the world buys from has not changed – it's Cisco. No brand name in the world is more trusted for establishing a reliable network.

An IT pro may disagree with the assessment and argue that F5 Networks or Juniper or whoever provides better and more reliable equipment, but decision makers consistently purchase Cisco. They are in a league of their own when it comes to sales and the company currently has enough cash to purchase their five nearest competitors *combined*. Cisco is afforded the same luxury as the New York Yankees – anyone they can't beat they can buy.

Cisco makes for an interesting case study when it comes to buying a great business at the right *price.* In the year 2000 Cisco had a market capitalization of $467 billion (not a typo), $5 billion in cash, and earnings of $2.6 billion per year. Their market cap was a whopping 175 times earnings. The share price was roughly $60 dollars.

Since that time the company has succeeded mightily. They have increased earnings from $2.6 billion to more than $9 billion in 2013 and currently have $50 billion in cash. The company is much larger and much more successful than it was in 2000. However, the market capitalization over that same 13 year time period has fallen by $356 billion, or 75%, down to $111 billion. A $1 investment in Cisco in 2000 is now worth roughly 25 cents despite the overwhelming success of the company. The price in 2000 was insanely high and the price in 2013 was surprisingly low.

After backing out the cash we paid roughly 10 times earnings for Cisco. This multiple is much lower than many of our other purchases giving us an increased margin of safety. We like to have an ample margin of safety when buying a technology company - even one as dominate as Cisco.

Sell Decision – We sold Cisco after an earnings release that resulted in the stock jumping 12%, netting us a 15.5% gain in about 4 weeks. This sale decision mirrored that of Apple's. Both companies had a very large cash positions relative to their market cap – which greatly reduced downside risk but limited the upside.

Royal Dutch Shell PLC ADR Class B

Ticker: RDS.B
Purchase Year: 2013, Sale Year: 2013
Purchase Price: $65.50, Sale Price: $71.76
Gain: +9.56%
Purchase Year: 2013, Sale Year: 2013
Purchase Price: $65.86, Sale Price: $71.50
Gain: +8.56%

Purchase Decision – Royal Dutch Shell is an oil and gas exploration company. They were founded more than 100 years ago and have grown to be one the most profitable businesses on the planet. In 2013 they earned more than $20 billion dollars. All of the major oil and gas exploration companies have similar economics – in general you multiply the number of barrels of oil or cubic feet of natural gas produced times the market price and subtract the expenses. It is extremely difficult, if not impossible, to forecast the future prices for oil or gas, but we do know that over time this is an extremely lucrative business and will continue to be. The supply curve for oil must eventually slope negative and owning these producing assets will be quite valuable. The reduction in supply may happen in 10 years or 1,000 years, but even during the interim the economics of the industry are quite attractive. Here is one of our favorite aspects of how income is generated…

In order to make money as an oil and gas exploration company you must have rights to land, either purchased or leased. Without the rights you cannot extract these precious resources. As Lex Luther from Superman famously stated, "*Land is the one thing they aren't making any more of…*", and companies like Royal Dutch Shell have accumulate massive land empires. They have more than 140 million acres of land purchased or leased globally. Land empires like this are built one year at a time over decades and create large barriers to entry.

When we purchased Royal Dutch Shell it was trading at a 52-week low and roughly 9 times earnings. We bought the Class B shares to avoid the withholding of taxes associated with the Class A shares. Our logic at the time of purchase was that the earnings were safe, the business was extremely cheap, and it paid a 5.5% dividend. Owning this business was superior to cash. Our objective was not outlandish returns, but a very moderate return on capital while we searched for additional investments.

Sell Decision – After we owned Royal Dutch Shell for about 2 weeks the price appreciated nearly 9.5% and we sold to protect the gains. We would have been content holding the stock and collecting the 5.5% dividend while waiting for a superior investment, but after the increase the position had served its purpose. We didn't know the price would increase in such a short time, but we were delighted with the result.

Shortly after we sold our position the stock retreated back to 52-week lows and we repurchased. Our logic was identical to the initial purchase and for a second time the price increased quickly. We sold again for the same reason as our first sale. In total we made almost 20% buying and selling Royal Dutch Shell this year. This was largely by luck, but we'll absolutely continue to purchase strong companies with great dividends as an alternative to cash if the price is right.

Joy Global Inc.

Ticker: JOY
Purchase Year: 2013, Sale Year: 2013
Purchase Price: $53.87, Sale Price: $50.25
Loss: -6.72%

Purchase Decision – Joy Global manufacturers mining equipment for the extraction of coal and various other metals. Extracting coal from the ground is an extremely important part of the global economy. The majority of all electricity worldwide is generated from burning coal and it is extract from the ground at a rate of 32 million lbs per *minute*. Joy Global is the best in the world at manufacturing the massive equipment required for this monumental task.

Joy Global stands out from other heavy equipment manufacturers in some very big ways. First, they operate with a debt-to-equity ratio of 0.5:1. This compares to their biggest rival, Caterpillar, which operates with a debt-to-equity ratio of 2:1 – or nearly 4 times the debt of Joy Global. In addition to a conservative capital structure they also have very high returns on equity of more than 25%.

One concern we had was that they operate in a cyclical industry that has benefited greatly from the massive expansion of China's coal mining efforts during the last decade. The cyclical nature of the business and reliance on China was offset by the revenue generated through after-market sales. After-market sales include repairs and services performed for existing equipment that was sold during previous years and is currently in operation. This revenue is highly recurring by nature and more stable than that derived from original equipment sales. The after-market sales comprise nearly 50% of their overall revenue which helps to mute the cyclical nature of the business.

We were able to purchase the business at roughly 8 times earnings – the cheapest of all businesses we bought. This price seemed attractive to us at the time given the recurring revenue, strong return on equity, low debt to equity, and importance of coal globally.

Sell Decision – We sold Joy Global at a -6.72% loss. Shortly after making our purchase we met a CEO that was running a renewable energy start up. They are developing a large scale renewable energy source that we had never seen before. After the meeting we believed that a renewable technology of that magnitude would change the energy landscape over the next 30 years and it made us uncomfortable thinking about the future of the mining industry.

Governments all across the globe are paying the best and brightest minds on the planet to solve our insatiable need for energy and eliminate coal as an energy source. We are confident that the myriad of talented individuals working on this problem globally will succeed and the demand for coal will drop. We are hoping this happens sooner rather than later.

After the meeting and some reflection we came to the following conclusion: The businesses we purchase benefit mankind in enormous ways, but the world would benefit greatly if the equipment produced by Joy Global was no longer required or at least in significantly less demand. Additionally, as an owner of Joy Global we were effectively betting against the best and brightest. That was a bet we didn't want to make…and for that reason we sold. We should have realized this *before* we made the purchase and for that we apologize.

Side Note: If you're curious how selling Coach bags for $300 benefits mankind we'll tell you the story of a friend that bought a Coach bag for his wife and the benefits that ensued.

Businesses Presently Owned

The businesses included in this section are those we presently own. These businesses are all similar in that we believe they're extremely impressive and undervalued to varying degrees. We've included in this section the logic behind why we made the purchase as well as our expectation for the investment. The gain or loss is calculated from the time of purchase until market close December 31, 2013.

Table 2: Businesses Presently Owned

Business	Symbol	Purchase Price	Current Price	Gain (Loss)
Higher One Holdings Inc.	ONE	$7.10	$9.76	37.46%
SolarWinds Inc.	SWI	$32.78	$37.83	15.41%
Cisco Systems Inc.	CSCO	$21.08	$22.43	6.40%
International Business Machines	IBM	$183.85	$187.57	2.02%
National Interstate Corp	NATL	$24.62	$23.00	(-6.58%)

We begin with Higher One on the following page…

Higher One Holdings Inc.

Ticker: ONE
Purchase Price: $7.10, Price At Year End: $9.76
Change: +37.46%

Purchase Decision – Higher One provides loan disbursement services to higher education institutions. When reimbursements occur they offer the student the option to have their funds deposited in the student's bank account or a OneAccount. If a student opens a OneAccount every transaction that occurs using their Higher One Debit card creates revenue for Higher One. This is the primary way they generate income. Our favorite element of this business model is that the party responsible for selecting the service is different from the party responsible for paying for the service. This removes all pricing pressure. Here is how this situation occurs:

Higher education institutions are responsible for selecting how to process student loans. This is a very easy sell for Higher One because they can remove all administrative costs associated with processing student loans at almost no cost to the institution. Once the institution selects the Higher One to provide the service the students can elect to have a OneAccount or use their current banking account; with about 50% selecting the OneAccount. Higher One then gets paid from the students for various fees charged to the OneAccount and from interchange fees that occur using the debit card, which means the students and merchants are paying for the service Higher One provides, whereas the higher education institutions are the ones selecting the service.

Now, we weren't the only ones that noticed this disconnect. Regulators also took noticed and stepped in and changed how much Higher One could charge for various fees on their OneAccounts. After this change in regulation there were two things that needed to be evaluated prior to investing: 1) Are students being treated fairly when they open a OneAccount? and 2) How much money will Higher One make under the new rules?

We calculated that the fees charged to students would total roughly $4 per month based on ATM transactions, overdrafts, etc. and would actually be *significantly* less for students that were responsible with their Higher One debit card. It was very comparable, if not superior, to having a debit card with a bank. We also calculated that after the fee adjustments Higher One would be earning at least $30 million per year.

After all the revisions to their business model we were delighted to buy Higher One at roughly 11 times their new income level. Nothing material had changed in the number of students they serviced, the number of higher education facilities serviced, etc. We loaded up.

Expectation – Higher One services 1,600 of the 4,000 higher education institutions in the United States. With such a high market share we used an extremely modest 4% growth rate in income which should be extremely feasible in light of the fact that they have started cross-selling new products to the 1,600 schools they service.

In light of their low prospects for growth we would be willing to sell our portion of the business at an overall price of $475 million. This would equate to a 50% gain on our purchase. Originally we had an overall price target of $550 million, but revised this downward when the founding CEO, COO, and other key individuals announced they would be leaving the company. While this will have an impact we believe the overall business model is strong and earnings targets will be hit regardless of the leadership turnover. Since our purchase Higher One has risen 37% and is therefore getting close to our sell value.

SolarWinds Inc.

Ticker: SWI
Purchase Price: $32.78, Price At Year End: $37.83
Change: +15.41%

Purchase Decision – SolarWinds Inc. sells network monitoring software to small businesses around the world. They are in the middle of an explosive growth period compounding their income at a rate of more than 20% per year for the last six years. The beauty of this business is that they currently service only 150,000 of the potential 11 million small businesses globally – meaning they have a lot of room to run.

Their business model is fantastic because their product is extremely valuable and they are the lowest cost provider. Networks are an extremely important part of any business and when they go down serious opportunity costs are incurred. Paying a small license fee of $8,500 and then $1,500 per year is a spectacular investment to keep a network up a running. This price point is extremely low relative to all other players in the space and SolarWinds is gobbling up market share at an incredible pace.

In addition to being the lowest cost provider their customer base is extremely satisfied with the product. Their customers renew their maintenance contracts each year with a mid 90% renewal rate making their income extremely predictable. They also have received a myriad of awards and accolades for the best software in its class. We believe that SolarWinds might be able to continue to compound their income at a rate of 12% per year for the next decade…a tall task, but one we believe they can accomplish.

When we bought SolarWinds their growth rate from new customers dropped from +30% per year down to +15% per year. This really didn't bother us in the slightest, but the price of the business plummeted precipitously. After the sharp drop we were able to purchase the business at roughly 15 times earnings – one of the most expensive purchases we made all year. We were willing to pay such a high price for two main reasons: 1) They had no debt and a significant portion of their income was recurring, and 2) They have a very high probability of rapid growth.

Expectation – Given our expectation for SolarWinds growth, we intend to hold onto the business as it grows and succeeds. Since the company has such a bright future and very little risk we would only consider selling the position if the price gets out of control on the high side (which it seems to do frequently). We would consider selling the investment if the price rises by 50% in the next 12 months, but at prices below this mark we'll hold on and let the good times roll.

Cisco Systems Inc.

Ticker: CSCO
Purchase Price: $21.08, Price At Year End: $22.43
Change: +6.40%

Purchase Decision – Yes, we repurchased Cisco. After selling for a 15.5% gain earlier in the year Cisco had a poor earnings announcement after earning $2.0 billion during a 3 month period. Not our idea of 'poor' earnings. They revised their 2014 earnings downward by roughly 10%. Our forecast of 2 – 6% growth over the next decade would include some +10% years and some -10% years, but in general the growth should be modestly upward and the earnings release and forecast were within the range of our original thesis. We repurchased Cisco at the same exact price we did earlier in the year.

Expectation – This investment is not going to be a homerun for us but it is much better than being in cash. Cisco's large cash position, the low purchase price, and strong competitive position gives us wonderful downside protection with a high probability of a reasonable upside. Our expectations are either 1) Hold onto Cisco at the current price and enjoy powerful share repurchases, a great 3.3% dividend, and 2-6% annual growth in the overall business the next 10 years, or 2) Sell it again if the price appreciates to an appropriate level.

International Business Machines

Ticker: IBM
Purchase Price: $183.85, Price At Year End: $187.57
Change: +2.02%

Purchase Decision – IBM has transformed their business model over the last 10 years and made a series of very impressive business moves. A decade ago their focus was on selling price competitive hardware products, but since that time they have transitioned to being the business partner of choice to develop enterprise software solutions. This business model is very similar to that of Infosys and Oracle – two businesses we also owned this year. I'd recommend reading the synopsis for those two businesses to understand why we like IBM's business model. IBM competes fiercely against both Infosys and Oracle to win new customers, but whoever wins the customer wins a long-term monopoly through the new relationship. The relationships for enterprise solutions are very deep and difficult to replace and IBM has more of these relationships than any other business with 430,000 employees in more than 190 countries.

We paid roughly 11 times earnings to buy IBM.

Expectation – IBM is another very mature business. They have experienced negative revenue growth over the last twelve months, but we don't expect a trend like that to continue for the next decade. The services they provide are much too beneficial and they will win their fair share of enterprise contracts over time.

Many analysts have been releasing very negative reports on IBM due to movements to cloud computing and Software-As-A-Service models. While this economic shift is going to impact IBM (and Cisco for that matter) in the short-term we believe the long-term prospects for both companies are bright. The reason for this belief is fairly simple – cloud computing moves the data center load from on-site centers that usually have significant excess capacity to third-party data centers where capacity can be more effectively utilized. The movement to the cloud will effectively increase the capacity factors for data centers globally, but over time the number of data centers must continue to rise. It doesn't matter if all services everywhere move to the cloud, when capacity factors for data centers globally are maxed out we will build more. This will happen sooner rather than later and IBM will be able to build customer solutions for clients.

We anticipate growth in the range of 0%-2% per year for the next 10 years on average.

IBM could actually be earning the same exact amount annually 10 years from now and our investment be extremely successful for one reason - share buybacks. IBM has been allocating the vast majority of their earnings to repurchasing shares for several years and many would argue that this has been a foolish way to deploy capital, but we couldn't disagree more. Repurchasing stock at 11 times earnings has the same impact on the business for remaining shareholders as acquiring new business relationships through acquisitions at 11 times earnings (which is nearly impossible, acquisition prices would be much higher). We would much prefer stagnant revenue and income growth at the business level with strong repurchases at 11 times earnings than acquisitions at 15 to 20 times earnings.

We are content to hold onto IBM as long as the price remains low so that their share buyback program can continue with great efficacy, but would be willing to sell if the market capitalization exceeds $240 billion or a 20% rise.

National Interstate Corp

Ticker: NATL
Purchase Price: $24.62, Price At Year End: $23.00
Change: -6.58%

Purchase Decision – National Interstate Corp sells insurance policies for commercial vehicles, such as semi-trucks or buses. They are one of the premier insurance companies in the business - posting profits in all 24 years of their existence with 22 years of underwriting[1] profits. In the last twelve months their underwriting performance has soured and their combined ratio[2] will be in excess of 100% for 2013, marking the 3rd time in their history that they did not earn underwriting profit. This performance must be corrected and we believe that it will.

In the insurance business there is only one way to correct underwriting losses – you must increase prices. The problem with this approach is that insurance is a price competitive business and when you raise prices you typically lose business. In the first six months of 2013 National Interstate drastically increased their prices and lost $35 million in premium volume, or 12% of their annual total. This was precisely what they needed to do in order to return to their historic level of profitability. Many insurance companies talk about their dedication to underwriting discipline, but very few actually take the actions required to post profits. This price increase and loss of customers is the exact type of behavior that has made National Interstate one of the most impressive insurance companies of the last 25 years.

A price increase like the one recently initiated takes time to play out. The policies that were written for the last two years were underpriced and raising prices today will not improve the profits of these old policies – it will however raise the profits on policies moving forward. It will take time for the underwriting profits to be restored – in this case likely between 12 and 24 months, but we strongly believe that larger profits are on the horizon.

National Interstate earned roughly $17 million in the last twelve months despite their poor underwriting performance. This income was derived from their large investment portfolio – slightly offset by losses on their underwriting. When underwriting returns to a normal level we expect profits in the range of $40 to $55 million – even after accounting for the loss of business through increased prices. This level of profitability is well within the historical levels of National Interstate and would equate to a forward looking P/E ratio of roughly 11 on our purchase.

Expectation – We expect National Interstate to return to their historic levels of underwriting profitability with a combined ratio of roughly 95% and to earn between $40 and $55 million. At that point in time we expect them to pay the majority of their earnings as a dividend due to limited growth opportunities. Any earnings that are retained will likely be used for highly profitable new lines of business or intelligent acquisitions. Their management team has demonstrated a strong track record for both.

We would be very content to hold onto the business if the price remains below $650 million, or $33 per share, but beyond that point we'd be content selling and searching for opportunities with higher prospects for growth. This would equate to a 43% upside from the current price level.

1) Underwriting profits are earned when the combined ratio is less than 100%. It is possible to have an underwriting loss, but still post profits as a company if investment income exceeds the underwriting losses.
2) The combined ratio is defined as the sum of all underwriting expenses and losses divided by the net premium collected. If this value is > 100% an insurance company posts an underwriting loss, if the value is < 100% the company posts an underwriting profit.

One important element of the National Interstate position is that the stock is very thinly traded. There are 19.6 million available shares and 10 million of those shares are owned by Great American Insurance Company, a wholly-owned subsidiary of American Financial Group, Inc. (AFG). Of the remaining 9.6 million shares only a few thousand trade hands each day which makes the price volatility quite high. It is not uncommon to see the price of the stock fluctuate several percentage points based on very small trades. Often times the trades are so small that we would be unable to make a meaningful purchase or sale at those levels. These very small trades are not reflective of changes in the true value of the business and we intend to completely ignore these fluctuations. Our focus is on how the business is performing and we will only pay attention the market price if it approaches our exit point of $33 per share. I'd recommend you ignore the price swings in the interim as well.

A Little On Diversification

The results we posted this year would not have been anywhere near as high, or as safe, if we had purchased a large number of businesses in the name of diversification. In order to further diversify we would have to compromise on the quality of the businesses we purchased or pay significantly more – both actions would hinder our results over the long term. Owning a concentrated number of truly impressive businesses is significantly safer, in our estimation, than owning a larger number of average businesses. When it comes to businesses we strongly prefer buying more of the best rather than diversifying into the mediocre.

The way we build our portfolio is fairly simple. When an incredible business is selling at an attractive price we typically place 10% of our assets into that business with the hope that it continues dropping in price. We start at the 10% figure so that if the business drops in value we can purchase more. The ability to dollar cost average as the price drops gives tremendous upside potential when the business reaches our target sale price.

For example, this year we purchased Apple with 10% of our assets at roughly $430 per share and then made a second purchase at $390 per share - lowering our average price to $417. When we sold Apple at $513 our returns and profits were higher than if the price drop and second purchase had never occurred. Constructing our portfolio in this manner leads to the highest percentage of our assets being in the lowest priced businesses that we believe have the strongest upside potential.

Looking Ahead – 2014

The relentless bull market of 2013 has made finding impressive businesses at brilliant prices more difficult than it was twelve months ago. We've positioned ourselves cautiously for the upcoming year and currently hold significant cash in many client accounts. The businesses we do own are very attractively priced.

In 2014 the name of the game for us is a single word: Patience. It may take quite some time for outstanding opportunities to surface. We ask that you practice patience with us and rest assured that these opportunities will present themselves. Keep in mind that we only need a few great ideas to perform very well. The money is made in the waiting.

Clarifications

For those of you that have questions about the returns in your account we would appreciate it greatly if you would read the following carefully because they answer some frequently asked questions and should put your mind at ease with respect to how we are managing your investment account.

Clarification #1 – Your results are different than what is reported on the preceding pages.

We manage all of our client accounts separately, which means that the businesses you purchased and how much you paid is dependent on when you opened your account or contributed funds throughout the year. For this reason all accounts have different results. The results reported are a collected average of all accounts. We wish that all accounts experienced identical results, but they do not, cannot, and should not.

We work extremely hard to make the best decision for each account based on the size of the account and when it was opened. If you are new to the firm your results are likely materially different than those reported – that is expected because you weren't with us for each decision we made this year.

You can, however, rest assured that as your account grows your results will converge to the firm average going forward. Smaller accounts and new comers take the most time to meld with the rest.

Clarification #2 – You may not have owned all the businesses found in this report.

When a business is available at what we believe to be an attractive price we review how much cash is available in each account and then purchase a position that we believe to be an appropriate size. If you did not own a business found in this report it is for one of two reasons:

1) You did not have an account when we made the original purchase. If you opened an account after we made an original purchase it is unlikely that you owned that business this year. We purchased the business on your behalf *only if* the business was selling for the same price we originally paid or less. If the business rose in price we did not make the purchase in your new account. This is to your advantage as it protects your investment principle. Don't be bothered that you missed some investments – there will be many ideas going forward.
2) You did not have enough cash in your account at the time of purchase. This only happens for smaller accounts (less than $5,000). We are more selective with what businesses we buy and how much we pay for smaller accounts. A larger account may make a purchase in a business at price of X, but we intend to pay less than X for the smaller accounts. Our logic is that if the price of the business drops we can purchase *more* in the larger accounts which lowers their cost basis. Smaller accounts do not have this luxury and we must therefore have a lower entry price to protect principle and maximize returns. Again, this will be to your advantage over time.

Clarification #3 – Returns for each individual business are from the time of purchase to the time of sale.

The sections of this report entitled "Businesses Sold In 2013" & "Business Presently Owned" describe each business that we purchased, held, or sold during this year. The returns presented in these sections are total returns – meaning the return of the investment from start to finish – regardless of duration. The calendar year of purchase and sale is also provided to show an approximate holding period. We find this presentation style simple, clear, and believe it is a fair way to evaluate the success of each individual investment.

Clarification #4 – The purchase price and sale price for each business may differ from your account.

The purchase price and sale price for each business is typically the same for all clients. Differences exist for individuals that opened an account after we made an initial purchase if the price of the business had declined from our original purchase price. Those new accounts will have a different and *lower* purchase price – meaning superior results. Additionally, smaller accounts may have a purchase price *lower* than that which is shown for the reasons stated in Clarification #2. In rare instances individuals did pay slightly more for a business than the original purchase amount – this only occurred when we thought the price was still very attractive.

Clarification #5 – Different accounts held different percentages of the same investment.

Accounts may have purchased a different percentage of a particular investment based on account size. This is to minimize the impact of trading commissions charged by our custodian to your account. For example, a $100,000 account may purchase 10% of a particular stock ($10,000), but a $5,000 account may purchase 20% of the same stock ($1,000). The trading commission of $17 represents 1.7% of the smaller accounts purchase price, but only 0.17% of the larger account. Had we purchased only 10%, or $500, in the smaller account the trading commission would be 3.4%. For this reason smaller accounts are typically more concentrated with a focus on the best of the best.

Disclaimers & Disclosures

Past performance does not guarantee future results, and a loss of original capital may occur. The information herein should not be construed as a recommendation to purchase or sell any particular security or an assurance that any particular security held in a portfolio will remain in the portfolio or that a previously held security will not be repurchased. Securities discussed herein may not represent a portfolio's entire holdings. It should not be assumed that any of the security transactions or holdings discussed herein have been or will equal or exceed the investment performance of the securities discussed.

This report is provided for the general information of the clients of Selective Wealth Management LLC. It is not intended for distribution to prospective investors unless preceded or accompanied by an effective prospectus, which contains more information on fees, charges, and other expenses and should be read carefully before investing or sending money.

Returns for 2013 have not been independently verified.

<u>Definition of the Firm</u>

Selective Wealth Management LLC (the "Firm") is a registered investment adviser that was established in 2012 and has a single, all-cap, value-oriented, concentrated investment style approach. The Firm is based out of Lynchburg, Virginia and services institutional and retail clients in the United States. A list of the Firm's composite descriptions, as well as information regarding the Firm's policies for valuing investments, calculating performance and preparing compliant presentations, are available upon request.

<u>Fees</u>

Returns are presented net of management fees, custodial fees, withholding taxes and trading expenses.

<u>Fee Schedule</u>

The standard fixed management for all accounts is 1.25% and accounts are billed in arrears.