CAIRN INVESTMENT GROUP

Newsletter and Quarterly Update **September 2014**

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Important Reminders:

- Bank Holidays October 13 & November 11—No Checks—No Settlement
- NYSE Closed for Thanksgiving Day
- NYSE Limited hours Friday November 28

CAIRN INVESTMENT GROUP

121 SW Morrison Street
Suite 1060
Portland, Oregon 97204
Phone: 503.241.4901
Fax: 503.241.5699
E-mail: info@cairninvestment.com

Greetings from the Northwest.

The world is being pushed and pulled in many directions. Some directions seem like problems that we never thought we'd have to worry about, some directions seem like problems that ought to be quite solvable. All of this is global noise going on in the background as we are experiencing one of the most beautiful fall seasons in the Northwest. The weather is spectacular, the pumpkins are turning color, the leaves are beginning to float down and it is warm, warm, warm. That late in the summer, low sun angle, dry, warm and nice.

This quarter's letter is going to be rather brief, as I want to make sure that Tim and Mike have an opportunity to jump in on some topics that are of interest. We regularly reflect on our "wall of worry" and those things that are consistently putting pressures: positively, negatively and sometimes ambiguously into the market. The noisiest news lately has come out of the Fed and the notion that maybe the economic impact of ending quantitative easing (QE) will be felt across the board. Throughout this period of market volatility I continue to argue that basically it will have no effect. I believe the logic which caused the volatility is flawed. Many market watchers assumed that if QE was a stimulus program then the removal of the stimulus would certainly need to have a negative effect on the economy. Nope, the economy is strengthening.

These worries we have now - the worries about what lies ahead after having many, many months of economic recovery - are certainly less ominous than the worries we had in 2008 and 2009. I was interested last month when I saw an article in the Wall Street Journal stating that former Federal Reserve Chairman, Ben Bernanke, told a federal court something he had never before stated publicly - the 2008 meltdown in financial markets actually was more severe than the market crash that fueled the Great Depression. "September and October of 2008 was the worst financial crisis in global history, including the Great Depression." Well, we've got that worry behind us. Now much attention is being directed to what is going to happen as interest rates increase.

Whistler, BC *Photo by Jennifer U*

I dug back through some of my files and I have a few thoughts on that topic. In general, the idea that the Federal Reserve would begin to increase interest rates does not alarm me. The primary reason to increase interest rates would be a reflection of an improving economy. At 62 months and counting, the U.S. economic expansion that began probably about the middle of 2009 has lasted longer than the average U.S. recovery. My thinking is that despite the longevity, the recovery we're experiencing still has plenty of room to run. There is a lot of slack in the economy, or, maybe better said, capacity in the economy. Last week's market volatility was tempered at the end of the week by some wonderful employment numbers that showed employment is still growing. Generally, the type of recovery that you live with after a housing bubble bursts, which is what really happened in 2008 and 2009, is a post-burst recovery that tends to be much slower and longer than normal. During a cycle of tightening, or increasing interest rates, it appears that increasing rates may have little impact on stock markets, and economic growth is maintained. To be sure, we must always balance the realities of today while we're comparing them with the path that history has left for us to study. In general, policy-rate-hikes or interest rate increases are preceded by accelerating economic activity and tightening of economic constraints. Additionally, economic growth is typically continued during the rate-hike-policy cycle. After the rate-hike-cycle, growth remains positive and tends to moderate, easing economic constraints. It's also curious to see that generally the longer-maturity bonds that people hold in their portfolios begin to sell off ahead of interest rate-hike-cycles. As we think about the yield curve going from lower to higher, that yield curve typically tends to flatten out during a period of increasing interest rates. It's not unusual for equity returns to be a little stagnant over the first few months of the period of time when interest rates are increased, but they typically return to an upward direction shortly thereafter.

One of the things that I have watched with quite a bit of interest is the strengthening U.S. dollar, particularly as it is compared to the Euro. I suspect one of the driving forces behind this has been the significant increase in energy production within the United States. A lot of these factors are beginning to lead me to the notion that we are going to have a good solid GDP (gross domestic product) number of around 3% in the U.S. for the next several years, and that Europe in general will lag behind, maybe by as much as 1%, which would put Europe's GDP at about 2%. And in another 2 or 3 years it might even be that Americans feel that European travel is a more reasonably priced holiday.

Speaking of holidays, I had a chance to take a bit of a road trip down to the San Francisco Bay area, and that put me in close proximity to some of the most vigorously growing Tractor Supply stores on the West Coast. Tractor Supply doesn't have a location in Oregon and so I was delighted to pull off the freeway in Northern California farm country and check out what has been a really strong retail story.

We've had a change at Cairn Investment Group. Kris, our first voice and often first face that would greet people as they arrived at our office, has moved on. We're going to miss her. She has left for a new occupation in an industry that she enjoys – the Health, Beauty and Wellness Industry. This will give all of us at Cairn an opportunity to get to know Farima, who is moving from Bellevue to Portland to be in the uber-hip Portland scene. She's leaving a firm in the Bellevue area that is similar in size to Cairn. We welcome her and invite you to get to know her.

Probably the second most significant topic behind interest rates that people have been talking about is credit card identification theft, and in general personal information theft. Tim had a chance to answer this question for one of our investors recently, so I thought I would turn this letter over to him so he can let you know about the things that we do to be as good as we possibly can at keeping everyone's information safe and secure.

— What are things coming to? After you see that Target, Home Depot, Jet Propulsion Labs and Bank of America have been hacked, it's impossible to say that anyone is totally secure. When the wrong guys with enough horsepower target a specific company, they have a good chance of getting into some part of that firm's system.

We at Cairn continue to upgrade our systems and procedures as threats and technology evolve. Right now, all of our desktops have a remotely managed anti-virus software that is continuously updated. Our server has its own resident version that is updated daily. Positioned between our server and the internet is a firewall device called "Sonic Wall" that monitors and restricts traffic in and out of our office with built in algorithms and the ability to completely shut off access ports if needed. There's not much more we can do on that front beyond unplugging from the internet completely. Since we need this connectivity to trade, move money, communicate via email, etc., this is the space we must operate in.

A recent article on the website MarketWatch.com titled "Your adviser could be an easy target for cyber crooks" included "4 questions to ask about cyber-security." Here are those questions and our responses:

Do you use 2 factor authentication? Yes for entry into the system that allows movement of money, change of address or trading. Prior to accessing the trade system one needs to gain general entry on to our desktops. For this we use a password, changed every 90 days, with a minimum complexity level rated by Microsoft as "Complex." 2 factor authentication requires that each of us use a device that generates a unique number that is good for only 30 seconds. This is entered in conjunction with a password to gain entry. Anyone "hacking" in and stealing a password would be frustrated to learn that they cannot proceed without this number.

Do you use secure email? Yes, but rarely. Cairn's policy is to limit the type of information shared via email to not include account numbers or personal data. If we must, we will send a passcode protected .pdf with this information. We have a secure channel to communicate with our custodian on

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private matters.

If I give you an instruction, what do you do? Many activities such as trading are limited to verbal instructions only. Email instructions can be taken for money movements between a client's account and an established bank connection that was created with an actual client signature. Money movement to third parties requires signatures, principal review, and computerized signature verification.

Do you have programs in place to detect unauthorized activity or account intrusions? We receive alerts when an activity occurs in an account that was not initiated by Cairn. Additionally, we review cash flow and trades daily and reconcile with our expectations.

Most importantly, we continue to learn. Recently, a client's personal email was hacked and the criminal tried to use the information he gained to trick us into sending funds to a third party. It was amazing how much he knew about our client's family! Our systems did pick up on this and all ended well; we tweaked a couple of thoughts on our processes and now feel even better prepared. These criminals are pretty smart, so I'm sure they will try something new and more creative at some point.

Please continue to be cautious with your own systems. Never go on the internet without anti-virus protection, don't open emails that look suspicious, and please never send us private information via email that might make you vulnerable to cyber thieves. *– Tim Mosier*

Thanks, Tim. In addition, Mike would like to update us on one of the new smart bank cards that is likely to be available to some of our investors who are travelling far afield. So Mike, what's the update?

— The new Schwab Bank Smart Chip Debit Card, featuring smart chip technology, has arrived. Smart chip debit cards feature an embedded chip, giving users an added layer of security. Most of Europe, Asia, and South America have already converted to a smart chip requirement, so you will need this new card if you are traveling internationally.
We have heard that the regular "magnetic strip" credit and debit cards

Tractor Supply Store *Yreka, California*

do not always work overseas, so you may want to check with your bank(s) regarding the smart chip technology. The U.S. has until mid-2015 to convert current "magnetic strip" cards with the new Smart Chip feature. Current Schwab debit card holders will receive a new Smart Chip debit card when your current card expires.

If you are planning an international trip and plan to use the Schwab debit card, please contact Cairn so we can request a new card for you ahead of the scheduled card reissuance date. *– Mike Wieck*

Thanks, Mike. And with that we'll say enjoy the rest of fall and happy trails to all.

Jim

Jim Parr, Principal

Cairn Investment Group, Inc.