January 15, 2015

Dear Investor,

Client accounts finished 2014 up 9% on average. For comparison, the S&P 500 (large company index) finished the year up 13.6%, the Russell 2000 (small company index) up 4.6%, and the Barclays US Aggregate Bond Index finished up 6.0%. The average return of the three indexes was 8%.

For most of the year client accounts were roughly equally divided between large company stocks, small company stocks and fixed income investments. Given that mix the average return of the three indices is a reasonable basis for comparison. This year's performance, net of fees, was slightly above the three market average.

Although many stocks are fully valued, I see attractive opportunities among smaller companies whose stocks did not keep pace with operating improvements and earnings growth in the underlying business. I expect our investment concentrations in these names to increase in the next year.

<u>Notes on current holdings</u>

One of our better performing holdings early in the year, Infusystems, gave back some of its price gains this quarter as a consequence of third quarter pressure on sales and earnings. Infusystems provides billing, financing, and customer support services to users of ambulatory infusion pumps. The pumps are used primarily to administer chemotherapy for colorectal cancer, although usage is gradually expanding to treat other cancers and to manage chronic pain. While still solidly profitable in the third quarter, the company reported lower reimbursement rates from insurers, as patients shifted to new plans made available under the Affordable Care Act. Some of these plans had lower negotiated rates of payment to Infusystems, and some had no reimbursement contract in place at all. Management has described this negative shift in payer mix as now largely complete, and expects results to improve in subsequent quarters.

Ongoing pressure on reimbursement rates, both from Medicare and private insurance, is one of the primary business risks for health care service and manufacturing companies. Even businesses that have been less susceptible to payment pressure in the past, such as pharmaceutical and biotechnology companies, are beginning to feel pricing pressure from large purchasing organizations that seek to reduce their costs. Given this, the best businesses to own in the sector will be those that lower the overall cost of care. Infusystems fits into this category, as its services reduce the need for long and expensive hospital visits. I remain optimistic about the company's longer term prospects.

I restarted an investment in Liberator Medical, a distributor of disposable external catheters and other medical products. Liberator was one of our best performing investments in 2013, but I sold the holding at the beginning of this year after the stock rose to what looked to be an unsustainably high price. Since then the stock has retreated, despite solid earnings gains.

Liberator's business is highly predictable and generates a good deal of cash. The company has steadily gained long term customers by advertising its products on television. Once customers sign on, Liberator provides them with a monthly supply of external catheters, the delivery of which is billed to Medicare and private insurers. Many customers stay with Liberator for the rest of their lives, creating the equivalent of a multi-year annuity for the company. As the company's base of customers grows, so grows that annuity.

Like other health care providers, Liberator's earnings would be hurt by reductions in reimbursement rates. This risk is mitigated by the relatively low cost of Liberator's service: a month's supply of disposable catheters costs roughly $150. I estimate Medicare would save less than $30 million annually by substantially reducing payment rates to

DSW Investment, LLC
878 Lawrenceville Rd, Princeton NJ 08540
P:(609) 430-8407 F:(866) 202-2204
www.dswinvestment.com

disposable catheter providers. That number appears to be too small to justify much attention from the agency, especially considering that the use of disposable catheters decreases the risk of infection, and thereby reduces healthcare costs elsewhere in the system.

Broader Market and Economic Outlook

US economic activity, as measured by GDP, expanded 5% in the third quarter. This was well above expectations of most observers. The growth was a consequence of stronger spending by both individuals and some government agencies. Most observers now anticipate the year 2015 will be one of moderate growth, low inflation, and low interest rates. This would be a favorable environment for both corporate earnings and stock prices.

In addition, the steep fall in oil prices is likely to be beneficial for the global economy, although I think it likely that prices will rise later in 2015. In the US the increased consumer purchasing power resulting from lower gasoline prices will be partially offset by job losses in the US energy sector. However, for a number of large US trading partners – China, Japan, and Western Europe – lower fuel prices should significantly increase consumer purchasing power without significant offsets. That should provide welcome stimulus to slow growing European economies, as well as healthier economies in Asia.

The most obvious risk to markets is the timing of interest rate hikes by the US Federal Reserve. The US stock market has generally traded on the principal that the longer the Fed waits to raise rates, the better for stocks. There have been recent intimations that the agency will wait until late this year or possibly 2016 as a result of continued low inflation below the Fed's 2% target.

Some portion of the favorable backdrop for stocks is already reflected in market prices, with stocks trading towards the high end of historical multiples relative to earnings. As of yearend, the S&P 500 was priced at 16x projected 2015 earnings, and the Russell small cap index was slightly higher. That high starting point will likely be the biggest constraint on stock performance in 2015, even assuming continued growth in the US economy. That said, I continue to see stocks which are reasonably priced relative to earnings and business quality. Those investment opportunities, in the context of an improving, but still fragile US economy, leave me cautiously optimistic on the outlook for 2015.

As always, feel free to call with questions.

Best wishes for 2015,

Doug

Note: This information is intended as a general discussion of past account performance and investment strategy. It is not a recommendation to purchase any specific security or type of security. An investment in securities involves the risk of loss. Douglas S. Weiss is a registered investment advisor, member FINRA. Client performance is based on the arithmetic average return across all accounts managed for at least one year, net of management fees. Data is unaudited. Individual client returns vary reflecting risk profile as well as tax and other considerations. S&P 500 index return is based on total index return, inclusive of dividends.

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