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Introduction

The market as described by the S&P 500 continues to drift in 2005. The index was down about 1% at the end of Q2 and almost exactly flat as I write this in late August. The S&P 500 is only a rough proxy for the market, however, and different market segments tend to perform differently. I'll discuss some specific market segments in a moment.

Knowin' Yerself

Poker Hall of Fame member Puggy Pearson wisely observed that one of the keys to winning at poker is "knowin' yerself". The same thing applies to investing, where it is important to both know what you know, and know what you don't know.

Warren Buffett put this eloquently with his "circle of competence" concept. The idea is that an investor has areas of knowledge where he can competently assess business situations, which are within the circle. Just as importantly, the investor has to avoid situations outside that circle. As Buffett wrote, "You only have to be able to evaluate companies within your circle of competence. The size of that circle is not very important; knowing its boundaries, however, is vital."

My investment ideas are driven by what I know, not by some abstract need to diversify. Diversification can decrease risk, but diversifying into areas where the investor can't properly evaluate the prospects is dangerous. I constantly look for investments in the areas of the market where I believe I am competent. I don't, however, waste any time on any other haystacks.

Over time, my circle of competence grows, as I learn about additional market segments that interest me. For example I now know a lot more about structured finance and mortgage securities than I did 3 years ago. The book I brought with me to the beach this year was not a Grisham paperback, but Fabozzi's "Handbook of Mortgage Backed Securities", all 877 glorious pages (I bet you wish you hung out with me on weekends). Certain areas of securities analysis just grab me – years ago I couldn't get enough of investment conglomerates (what Marty Whitman calls "wealth-creation companies"), and these days it is structured finance companies and regional insurance businesses.

Market Segments

The weighting of our portfolios in a particular segment is always driven by the individual opportunities in that segment. I don't start the day thinking "I'm going to buy some small caps today" or "gee, we're light on oil and gas companies". Rather, I continually research all market segments with which I'm familiar, and I either find opportunities or I don't. Historically, for whatever reason, the opportunities tend to cluster in one segment or another, though it is strictly a "bottom-up" phenomenon.

Over the past couple of years I have found many opportunities in financial stocks, particularly structured finance companies. These include business development companies (BDC's), which I discussed in my last newsletter, and companies that securitize and sell pools of loans to investors, nicknamed "securitizers". As a result of the opportunities I have found, our portfolios currently have a heavy weighting in financial stocks.

Financial stocks have generally not done well so far this year due, I believe, to an uncertain interest rate environment, and concerns over the debt level and credit quality of consumers. The bloom is also coming off of the rose for this sector, which saw an ideal interest rate environment in 2002 and 2003, and has changed for the worse as Greenspan has been steadily marching short term rates upwards.

Because of our heavy weighting in this sector, our performance has been negatively impacted in the short term, though I don't believe there have been any permanent impairments. The companies in which we are invested have important advantages that I believe will eventually lead to superior performance, even if the current performance is a bit weak. In all cases, I believe they were substantially undervalued when I bought them, and the ones that have fallen are, I believe, now even more undervalued. I constantly check and re-check my analysis and assumptions, and thus far I am satisfied that the investments are sound, despite some short term declines.

Over the past couple of years, small cap stocks with decent earnings performance have done extremely well. In many cases I think the stocks have done better than their companies. I bought many of these stocks years ago at dirt-cheap prices and enjoyed excellent performance for a while. Most were sold for good profits over the past few quarters at what I thought were high valuations. Our exposure to this segment is now small because I believe valuations of the companies that I deem investment-worthy are too high.

Oil and commodity stocks have done extremely well, a result of high and rising oil and commodity prices. However, we have had little exposure to this sector due primarily to the difficulties in predicting oil and commodity prices. Making such predictions amounts to making a global macro-economic assessment which, while not impossible, is a whole discipline unto itself. Nobody can disagree that oil prices are very high today, but will they stay there, and for how long, and why? If I really had an opinion on that, I would be looking at oil futures. Many oil and commodity companies are foreign, and with these, you must consider numerous variables for a different government, a business regulatory environment that is almost always less favorable for investors, foreign currencies, etc. Such an environment involves numerous additional risks that are hard to assess.

One opportunity I have found in this sector is Prospect Energy, a domestic company run by management who I believe has expertise in this area and who is working for the benefit of shareholders. Prospect is also in the finance sector since they are an investment company and their investment performance is central to their business. I'll describe this company later.

We don't currently own many large caps or "stalwarts", though recently many are coming up on my radar as undervalued. This is a bit surprising since the economy is not doing badly, and stalwarts generally have pricing power and ample equity financing. This makes them resistant to the twin swords of inflation and rising interest rates, which are both risks in the current market that I have discussed in past newsletters. Many of these companies are those that you would love to own at the right price.

Wal-Mart for example is at its lowest stock price in about 5 years and its lowest price to sales ratio in almost 10 years. Berkshire Hathaway is nearly drowning in uninvested cash, and has been able to make several new acquisitions lately, and its valuation has been low over concerns about its largest insurance unit. Anheuser-Busch is also a bit cheap, and it was announced that Warren Buffett has been buying its stock. These are just three examples that are under consideration, there are several more. You shouldn't be surprised to see some of these types of stocks show up in our portfolios shortly.

Updates

Here is a brief update on each of our financial stocks. In some cases the stock has declined recently. In all of those cases, I believe the investments are still sound, but are having short-term issues. Many of the financial stocks have a high dividend yield, some in the 10-16% range. In all cases I believe the dividend to be sound, so this needs to be considered when you see the stock price falling.

<u>Commerce Bancorp (CBH)</u>
CBH is a NJ based bank whose model is "bank as retailer". They focus on customer service and convenience, long hours, and growing their deposit base organically (as opposed to by acquisition). Their growth in deposits has been over 30% compounded since inception, which is outstanding. They have been called the Wal-Mart of banking, and I believe the large incumbents such as Bank of America are ripe to be displaced in the market. There was a low-grade scandal at Commerce a few months ago regarding kickbacks to a Philadelphia official that drove the stock down. I thought the concerns were overblown and I was able to buy it for us at a great price. They are expanding into other regions including DC and Florida and I expect them to do well. They've recently gained a lot of attention from high profile analysts such as Jim Cramer (it was even mentioned on his crazy TV show "Mad Money") and Tom Brown's bankstocks.com, you can read more about them through their analysis.

<u>Novastar Financial (NFI)</u>
Novastar is a subprime mortgage lender that securitizes and sells their loans to large investors. We have held Novastar on and off for years. They went through a period that could be described as "printing money" in 2002 and part of 2003, when the interest rate and mortgage lending environments were very advantageous to them. Both environments have become more difficult, and as a result, the average yield they earn on their assets has been approximately cut in half. However, their portfolio has doubled in size during this time, so their earnings have remained approximately flat. The current dividend yield is about 16%, and while they pay $5.60 per share in dividends, they have over $10.50 per share in cash on the balance sheet. So I am content to accept the huge dividend yield, which seems very secure, while they navigate through the current difficult environment..

<u>Prospect Energy (PSEC)</u>
Prospect Energy is a development stage BDC, which I described in my last newsletter. Prospect raised cash for investments in the energy sector. The cash is about 60% invested, and the remainder is in treasury bonds. While the pace of investment has been below projections, the investments that have been made appear to be excellent. The company is under the cloud of an unresolved lawsuit related to their first investment, which I don't believe will have a major impact on their business, and I believe this is keeping the stock price low. As the lawsuit is resolved and they continue their investment operations, I expect them to prosper, but the stock may remain weak for a while longer. The current yield is about 5% (run-rate), which I expect to increase.

<u>Friedman, Billings, Ramsey (FBR)</u>
FBR is an investment banking, brokerage, and asset management company based in Virginia. They are one of the top underwriters of small cap equities and have established a reputation for savvy and scrappy operating, having built the business from scratch. They are organized as an REIT and thus

have a high dividend yield. They also originate and securitize subprime mortgages through NLC (a company similar to NFI, mentioned above) that they acquired in early 2005. I have been familiar with their operations on several fronts for several years. Of the three founders in the name of the company, only Billings is left. Manny Friedman was recently ousted from the company over a PIPE scandal earlier this year, which drove the stock price down prior to my purchase. While the ousting of a founder is hardly something that inspires confidence, and I anticipate a significant impact on Friedman's business areas, the remaining business units are well established and I expect them to provide solid if perhaps lumpy results. The current yield is about 11%.

<u>First Marblehead (FMD)</u>
First Marblehead is a first-mover and leader in fast-growing market for private student loans. First Marblehead helps lenders package and sell their loans to investors, similar to what Fannie Mae and Freddie Mac do for the mortgage market. They IPO'ed a few years ago, and loan volume has grown from $165M in 2001 to $2.7B in 2005, growth of 100% per year, though the growth rate is slowing. They receive both up-front and residual fees for this service, and currently earn more than the lenders themselves on the loans. The demographics for private student loan financing is very favorable, with tuitions and college enrollment both growing rapidly, and government programs are not able to satisfy the demand for financing. Immediately after I bought FMD, concerns were raised about one of their customers offering a service similar to FMD's but without FMD, which may lead to the customer turning into a competitor, and the stock fell by about 20%. This was exacerbated by FMD missing a loan volume target in their most recent quarter, which caused another drop. I believe these concerns are overblown, and I expect that the stock will recover and flourish. FMD continues to expand their customer base and grow volumes and revenues at a rapid pace, with margins expanding.

Closing

I hope that this letter has given you a better understanding of my investment process and some of our positions. Thank you once again for your continuing trust you have placed in my company to manage your assets. If you have any questions or concerns, please feel free to contact me by phone or e-mail at any time.

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