(703) 652-4613
(703) 738-6359 (fax)
http://www.tiddcapital.com

TIDD CAPITAL, LLC

1563 McNeer St.
McLean, VA 22101

Third Quarter 2009

Intro

The market rally that began in late March has continued, with minor hiccups, through the beginning of September. This rally provides welcome relief to investors who were shocked and confused by the perilous market declines in 2008 and early 2009.

Somewhat contrary to the market action, however, fundamental economic indicators have not turned overwhelmingly positive. Most of the "good" news is of the "it's not getting any worse" variety. This alone was enough to propel a significant market comeback, as pessimism knew no bounds in March. But the economy is still on shaky ground, with high unemployment and deteriorating commercial real estate markets around the country.

They say that bull markets end on good news and bear markets end on bad news. The stock market is a "leading indicator" – a view into the next 12-24 months. 12 months ago, the market seemed to think that the world was coming to an end. Today, it seems pretty sure that it won't, but that doesn't mean that we're out of the woods. Caution is still the word of the day for all investors.

Tidd Capital portfolios joined the rebound, with composite performance of +26% during Q2, well ahead of our benchmark S&P 500 which gained 16%. This best-ever quarterly performance snaps a worst-ever 6-quarter streak of declines. While we have not gained back everything we lost, Q3 has gotten off to a good start, and with the economy stabilizing, I am looking forward to better times ahead. Once again I am grateful to patient clients who have remained supportive through an extremely difficult period.

The rally, which started as a "bounce", has continued to the point that it became speculative. Surprisingly, many unhealthy financial companies such as AIG and Freddie Mac began to participate in the rally. Freddie Mac for example is still under government conservatorship, is 80% owned by the government, and is currently unable to earn enough to pay even the dividends on the preferred stock sold to the government in the bailout. However, the stock rallied over 300% in August. AIG, which is still in distress and trying to sell off enough assets to repay its bailout money, has doubled since April. Some have termed this the "cash for clunkers" rally – investors are paying cash for stocks that are real clunkers.

On one hand, optimism and speculation always cause wise investors to be cautious, and this time is no different. I am avoiding most of these companies that make headlines for this reason. On the other hand, the market has been volatile and valuations are all over the map, which provides lots of investment opportunities to those who can sift through the chaff to find the wheat. Consequently, there has been a lot of activity in our portfolios recently, which I'll describe in more detail in a moment.

Retrospective

The calm after the storm provides an opportunity to review our investing strategy to see if any significant changes need to be made. To recap, our investing philosophy is as follows:

1) Look for companies with above-average economic performance, solid financing, internally generated cash flows, and a defensible competitive position, run by capable and incentivized management teams
2) Buy into these companies at a substantial discount to readily ascertained fair value
3) Sell stocks when they trade at a value at or above fair value
4) Concentrate portfolios on the 10-15 best ideas

This relatively simple philosophy, often called "value investing", has provided investors with superior long-term returns over periods measured in decades. However, no investing paradigm is always successful, and this one is no exception. Every strategy goes through periods of a few quarters or even a year or two with disappointing results, and this one is no exception.

Investing with attention to value was a fairly easy way to avoid the "dot com" collapse of 2000-2001, since the technology stocks in the “bubble” traded at valuations that were obviously unrealistic. Many value investors (including yours truly) remained invested through this period and, by simply paying attention to basic valuations, emerged unscathed, and were able to pounce on the low prices that emerged in the aftermath.

In contrast, the meltdown of late 2008 and early 2009, it didn't really matter what your investment philosophy was, unless it involved stuffing cash in your mattress. Virtually every asset that can be traded declined precipitously, including stocks, bonds, real estate, commodities, etc. Everything declined in unison, and that included stocks of all valuations. Being a value investor may have even made a bad situation worse, because as stocks first declined, value investors pounced on "cheap" stocks, only to tie up their capital in stocks that were just beginning a long and deep decline.

In retrospect, our portfolios were drawn into this vicious whirlpool. In late 2007, when the cracks first started to form, stocks actually did not look expensive at all. The stratospheric valuations of the dot com era were nowhere to be seen, in fact many stocks looked like good buys based on valuation. What was not evident until later was that the solid-seeming financial results were built atop a quagmire of leverage and easy credit at all levels of the economy. Valuation ratios that were cheap by historical standards became very expensive when the value of virtually all assets fell by 50% or more.

One of the key advantages of value investing is being able to recognize the (usually brief) period where a stock is "cheap", and to buy it with confidence knowing that it is probably worth more than you are paying. But in order to buy a stock, you have to have either cash, or another stock to sell to raise cash. Therein lay the problem.

In the past, our typical holding period for a stock was between 18 months and 3 years. With a portfolio of 10-15 positions, there were always a few stocks ripe to be picked, which provided proceeds to reinvest. When new opportunities presented themselves, there were always a few other positions that could be sold at a favorable price to raise new funds for the new purchase.

One of the problems with the declines that started in early 2008 was that virtually all of the stocks in our portfolios, indeed almost all stocks on the market, joined the decline simultaneously. Never

before have I seen such a synchronized market decline. This made it impossible to sell any "winners" in order to make new investments – there were no winners.

Secondly, while I feel that I have maintained a disciplined approach to value investing, some mistakes were definitely made in the quarters leading up to the meltdown. In 2006 and 2007, valuations were reasonable, but truly cheap stocks became harder and harder to find. Again in retrospect, there were a few situations during this period where I "yes'ed" when I should have "no'ed".

Some companies were not necessarily expensive, but were earnings profits that depended in whole or in part on easy credit, and should have been avoided. First Marblehead and Novastar come to mind, which were detailed in past newsletters. Gladstone Investment Corporation is another example of this, which I will detail shortly. This stock was probably fairly valued when we purchased it, and not really cheap, which violates our buy discipline. And that "fair value" was based on the assumption that both the company and its peers had ready access to cheap capital. When the capital dried up, "cheap" became "expensive" and the stock declined.

This was a mistake that was avoidable if more discipline had been used. Generally speaking, there was a lot more danger in these fringe financial companies that I realized at the time. From here on out, I will be steering much wider of financial companies earning seemingly easy returns on equity and trading at multiples to book value.

Despite the mistakes, I don't feel that the underlying strategy needs a major overhaul. I don't take credit for the formula – it has been successfully employed by many a gray-haired and wealthy investor that has come before me. Sticking to a disciplined value investing approach means standing on the shoulders of giants. My implementation of the formula needed some adjustments, which I have already made, and I look forward to employing these changes in the current market environment.

First of all, our portfolios will carry a higher level of cash – I will shoot for 10%. This will leave cash available for quick, new investments, and will leave us better able to capitalize on extreme market events. Second, a greater degree of discipline will be employed when assessing valuations, especially in financial companies. Net asset value or liquidation value will be the anchor for most valuations, with any premiums to this value justified only very strongly.

These are fundamentally good times for value investors – we just need to stick to our knitting.

Portfolio Update

The portfolios have seen a lot of activity in the past 3-4 months, both in buying and selling. This activity comes as welcome relief from the deep-freeze we had been in since the end of 2008. First some of the sales:

Specialty Underwriters Alliance became the target of two buyout offers early in 2009, as mentioned in last quarter's newsletter. During the quarter, the share price actually traded above the most optimistic deal price. I sold all of our shares, as they had exceeded my opinion of fair value. This locked in a gain of more than 30% from our cost basis and more than 80% from the lows in March.

We held the publicly traded unsecured debt of Allied Capital Corporation, a specialty lender that got into some trouble during the credit crisis. These notes rallied 30% in early August and I sold our position at what I believed was fair value. We bought these securities in September 2008 for about

$10 per unit, received 3 interest payments totaling about 13% of our cost, and then sold them at prices ranging from $10 to just over $13. This locked in a gain of 13-43% from our cost and more than 200% from the lows in March. This experience demonstrates the interesting point that it is possible to make safe and attractive profits even when a company is in distress.

Gladstone Investment Corporation has unfortunately been a very disappointing investment. Despite making several core investments that appear to have been successful, the company has continually burned up shareholder funds with below-NAV share offerings and mismanagement of its debt. It faced a margin call on its debt in April, at probably very near the low point of investor confidence, and was forced to sell a substantial portion of its assets at hefty losses. I have been trimming our position ever since and seek to eliminate it shortly. Even including dividends, the investment has delivered us with a rare loss, about the same as the S&P during the holding period. In this instance, the price I paid to buy the investment did not include a sufficient discount to fair value, taking into considering the liquidity and financing risk the company had. I also did not anticipate the extent of the problems the company could encounter outside of its core investment portfolio.

On the buying side, Mass Financial is a merchant banking and investment operation based in Hong Kong and run by Michael Smith. As a merchant banker and provider of financing and liquidity to industrial companies around the world, Mass Financial has found the current environment to be very profitable. In mid-2009 the stock was available at a price equal to year-end 2008 book value, but at a substantial discount to what I believe the current book value to be. Michael Smith and his team have proven very adept at profiting from the special situations and market dislocations that occur in today's environment, and I expect them to continue to do so.

Origen Financial was formerly a REIT that securitized and sold loans on manufactured homes. A victim of the credit crisis, in mid-2008 they halted operations and sold off most of their assets, retaining a residual interest in their loan portfolio. Despite the economic downturn, the loans have been performing very well. The company is in limbo, collecting the cash flows from that portfolio. We did not own the stock until all these events had transpired – in this case we skipped the drama and invested during the aftermath at dirt-cheap prices. I estimate that the company will receive about $0.25 per share in cash during 2010 and over $1.00 per share in cash in 2011 several years after that. I bought the stock between $1.00 and $1.25, which would seem to be a fraction of its 5-year cash liquidation value. This situation is similar to ECC Capital, another defunct REIT in which we invested in late 2007, which provides returns of more than 250%.

We have been adding to our position in The Washington Post. Despite its name, the Post is not really a newspaper company, as less than 20% of its revenues come from its print business. More than 57% of its revenues come from its Kaplan for-profit education unit. Despite the economic downturn, and partially because of it, Kaplan has grown its business more than 30% over the past year. The for-profit education business tends to be counter-cyclical to economic downturns because, when people are laid off of work, they seek ways to become re-employed as quickly as they can, and Kaplan's vocation-based education is just the ticket. I think the Post is trading at about half of fair value, and look forward to better performance from the stock in the near future.

Wesco Financial is an 80%-owned subsidiary of Berkshire Hathaway, run by Berkshire's vice chairman Charlie Munger. Wesco's operations, however, are much simpler than Berkshire's. The company's value is dominated by a portfolio of 6 investments in publicly traded companies, one of which is the preferred stock and warrants in Goldman Sachs. This investment was part of a private investment made in Goldman by Warren Buffett in the depths of the crisis in 2008 and is proving to be extremely profitable. The warrants have a much greater impact on Wesco's value than Berkshire's.

Wesco currently trades at a discount of about 20% to liquidation value, which provides us with a way to invest in this basket of excellent investments at a substantial discount.

Western Sizzlin' is a small steak buffet restaurant chain based in Virginia. In 2006 it was taken over by Sardar Biglari, a young (then only 28) hedge fund manager. He has since turned the company into an investment vehicle, and used it to take over Steak 'n Shake, a much larger restaurant chain. Recently the two companies announced the intent to merge, which is when we bought our shares of Western. In the deal, we are due to receive 60% of our cost in debt paying 14% secured by Steak 'n Shake, and 40% of our cost in shares of the company's common stock. Mr. Biglari is young and somewhat unproven, but he and his team are value investors and heavily incentivized by the company's common stock. It should be interesting to see how they create shareholder value in the new combined company.

Second Routine Audit

As a registered investment advisor registered in the Commonwealth of Virginia, Tidd Capital is subject to periodic routine audits from the Virginia State Corporation Commission. Our first audit was in March 2006, which we passed without incident. We saw our second routine audit in August 2009, which I am pleased to report we also passed without incident. I take the compliance and regulatory aspect of the business seriously, and take every step to ensure that we remain in compliance with all applicable laws and regulations. I regard my clients as business partners, and feel that the best way to treat them fairly is through disclosure and remaining open to regulation.

Closing

I hope that this letter has given you a better understanding of my investment process. As always, if you have any questions or concerns, please feel free to contact me by phone or e-mail at any time.

Randall Tidd
President, Tidd Capital
703-652-4613
rtidd@tiddcapital.com