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First Quarter 2010

Intro

The S&P 500 finished the year with a 6% gain in the 4th quarter, which provided a 26% return in 2009. This bounce back from the 37% decline in 2008 represents the 5th best annual performance of the index in the past 15 years.

Tidd Capital portfolios returned, on average, 50% in 2009, handily beating the S&P 500 by about 24 percentage points. This represents our best year ever, topping the +42% in 2006. This excellent performance was both welcome and, to a large extent, expected. Stock valuations at the beginning of the year were clearly completely detached from reality (on the low side), and it was only a matter of time before they came back.

Despite the positive moves in the market, economic conditions are still difficult, as unemployment is high and most businesses are having trouble finding growth. This may seem paradoxical, but this pattern has been typical to previous recession / recovery cycles. For example, the best year that the Dow Jones Industrial Average has ever had was 1954, when it returned nearly 50% including dividends. However, the country was still in the midst of a recession that had started in July of 1953, and unemployment peaked in September 1954, doubling during the year. Yet the market increased by 50%.

The stock market is a leading indicator of economic conditions, based largely on sentiment and perceptions. It provides a picture – albeit not always an accurate one – of where the economy will be in the relatively near future. The positive performance of 2009 reflects not the unpleasant realities of the current crisis, but the likelihood that we have survived the crisis and the worst is over.

The market tends to overshoot reality in both directions, both positive and negative, due to a heavy component of emotion. And today's market activity does not usually reflect today's economic conditions. So the question every day is, where in the cycle are we? Is the market too happy or too sad?

Value investing provides an answer to this all-important question, by evaluating stocks not as fickle electronic wiggles, but as pieces of operating businesses. These businesses can be evaluated on their fundamentals, based on their cash flows, competitive position and management, completely independent of their market price. Rational valuations made with these criteria are not subject to the euphoria and depression of the markets, and as such they provide investors with a steady helm for navigating difficult waters.

Simply put, value investors say that stock prices are "overvalued" when market values are substantially higher than fundamental values, and "undervalued" when the opposite is true. Successful value investing means buying stocks that are undervalued, and selling when they are overvalued, while maintaining a long term view. This is precisely the process we follow in making investments.

Administrative Changes

I wanted to mention an administrative item before providing more detail about investments. Tidd Capital produces quarterly statements that are in addition to the monthly statements provided by the broker, and these statements detail the performance and fees associated with each client account (information which is not present on the broker statement). Ever since Tidd Capital was founded in 2004, we have used TD Ameritrade as our broker and provider of the data that goes into these statements. TD Ameritrade used to be known as just Ameritrade and was acquired by TD Waterhouse a few years ago. As a result of the merger, the combined company is changing their back office software, and unfortunately has discontinued the platform that I have used to produce our statements.

I am still assessing the impact, but at the very least, our Q1 statements will be delayed while I figure out if the new platform can support our current statements. One option I'm looking at is changing our quarterly statements to use some other software system, another is to switch from quarterly to twice-annual statements. I like the format of the current statements, but unfortunately may have to change them. My goal as always is to provide clients with concise, useful, and honestly reported data from which they can quickly determine their fees and performance. Please contact me if you have any questions, concerns, or preferences about how I handle this issue. I'll be back in touch as soon as determinations are made.

Top Down or Bottom Up

As an investor I am primarily a "bottom up" or fundamental investor, meaning that I look primarily at individual companies and their financial and competitive position, and make investment decisions based on that. Some analysts (investors or otherwise) are "top down", meaning that they start with high level macro-economic trends, and maybe never get to the level of detail of analyzing individual companies.

I and many other value investors have found that, on balance, bottom up fundamental analysis is the best way to make sound investment decisions and achieve good long-term performance. There are, however, exceptions to the rule. In late 2007, based on fundamental analysis, stocks were not particularly expensive, corporate profitability and returns on invested capital were good, and the economy seemed generally strong. But from a macro perspective, in retrospect, there was an enormous amount of credit and leverage risk throughout the financial system, banking standards were lax, and there was an enormous disaster brewing.

Macro analysis may have indicated that this was a good time to sell stocks, and in retrospect I wish we had done more of that, though fundamental analysis said that it was a good time to hold and buy stocks. Obviously, based on the blood bath in 2008, macro analysis had it right.

However, years like 2008 are extremely rare. The US economy and developed global economies have far more good and great years than they do terrible years, and making investment decisions based on missing the 100 year flood means missing all of the good years too.

To wit, according to the same macro analysis that could have hopefully allowed you to avoid the losses of 2008, the beginning of 2009 would have also looked like a terrible time to buy stocks. Unemployment was very high and still increasing, major government bailouts were still underway, the prices of everything from houses to lumber to oil were falling, and investors of every type were in a panic. However, according to bottom up fundamental analysis, the prices of individual stocks was outrageously cheap, and excellent returns to be found across the markets. According to fundamental

analysis, this was the time to buy, not sit on the sidelines, and anyone who did so enjoyed the big recovery in 2009.

Going forward, we will stick to our knitting and forever remain value-oriented bottom up fundamental investors, and treat years like 2008 as very rare and unavoidable storms. I will pay more respect to macro trends, but rather than try to become an overnight expert in macro analysis, I will be more diligent about diversification and avoiding the fringes of the finance industry. The only other thing I can say about the past 2 years is whew! I'm glad it's over.

Brookfield Asset Management

Brookfield is one of our core holdings and largest positions, and has been an excellent performer for us for more than 5 years. It has been very interesting to watch Brookfield over the past few years as the crisis unfolded, as the past 2 years have been a crucial test of their business model.

Brookfield is a sprawling conglomerate, but to briefly summarize its business, it owns and manages premium "real" assets around the world, primarily premier commercial real estate, renewable power plants and infrastructure assets (i.e. ports, terminals, electricity distribution systems, etc). Based in Canada, they have assets and offices around the world, primarily North and South America, Europe, and Australasia.

Brookfield makes heavy use of capital markets, third party and debt financing, and is constantly buying and selling assets, so the crisis involving credit and asset values put them at risk. With home owners around the globe defaulting on their loans, would Brookfield get into similar trouble with their office towers? These concerns were revealed in the plummeting stock price as it fell from about $37 to about $11.

Despite the market action, the answer has been a resounding "no", as Brookfield's results demonstrated that they showed prudence and conservatism in their past deals. Brookfield did not overpay for any assets, used a conservative loan-to-value ratio of 50-65, which means 35-50% equity, and the financing is usually fixed rate and long term. Just as importantly, after buying an asset, they lock in 10-20 year contracts for the revenues. For example an office tower will be leased on 10-20 year contracts to "A" tenants, a hydro power plant will pre-sell its energy production to large energy companies on 10+ year contracts, etc.

Once an asset is "put to bed" in this fashion, it can quietly generate cash flow for the parent company, come hell or high water, for about 10 years. These contracts are staggered, so that in any given year, only about 10% of them come due. So during even the worst financial crisis as what we have just seen, a majority of their business remains solid.

Hell and high water did in fact come, as asset values around the globe fell, yet for the most part, Brookfield's cash flows remained unaffected. Even though the market value of their assets probably declined, they had no reason to sell them, because the financing and revenues were on contracts that had years to run. They retained their cash flows and liquidity, and were in a position to go shopping while their competitors started to get into trouble.

The most common problem their competitors ran into trouble was by overpaying for assets financed with too much debt and lack of long-term contracts. Just like homeowners grew fond of "100% financing" and buying McMansion houses at peak valuations, many of Brookfield's competitors paid top dollar for office towers and infrastructure assets, paying for the purchases with lots of

borrowed money. They were also not diligent about refinancing this debt on a long term basis or establishing long-term revenue contracts. When the economy went sour, the value of the assets fell to below the value of the debt, and, without long-term commitments in place, they were forced to sell. This meant taking heavy losses at a minimum, or going into bankruptcy at worst.

Throughout its history, Brookfield has proven very adept at deal making, and has created most of its shareholder value through deals rather than simple asset appreciation. In the mid-1990's they obtained ownership of some premier office towers in lower Manhattan by buying them out of distress. Starting in 2009, they started to make more deals again, first by taking over Babcock & Brown to acquire a collection of infrastructure assets when the parent company was near bankruptcy. Later they formed a consortium of investors to raise $5 billion with the goal of buying distressed real estate assets. Using that consortium, they are in the process of bidding for General Growth, one of the largest shopping mall operators in the U.S. They have ample capital, reach, and expertise to continue the deal making throughout 2010 and beyond, and I expect solid returns as a result.

After the stock recovered recently to $25, Brookfield has outperformed the S&P for nearly every time frame over the past 5 years – the past 5 years, 3 years, 1 year, 6 months, etc. Our goal as investors is to outperform the S&P 500, and Brookfield is one of our largest positions, and is certainly helping to meet that goal.

Berkshire Hathaway

Another fascinating conglomerate is Warren Buffett's Berkshire Hathaway. Aside from providing investors with outstanding returns for decades, Warren Buffett's Berkshire Hathaway has also provided investors and analysts with a living case study in investing from which to learn. Buffett's recent deal for Burlington Northern is another fascinating chapter in this long and remarkable story.

This acquisition, by far the largest in Buffett's history, was transformational for Berkshire, and it goes beyond earnings per share. Buffett has provided a perfunctory explanation for the deal, citing Burlington's entrenched competitive position and the advantages of rail freight over other modes of transport. However, I feel that there is much more to it than this. The advantages that Buffett describes have been present for decades, during which time Buffett was perfectly capable of investing in the railroads, yet he never did. Berkshire is also the owner of McLane, one of the largest wholesale distribution companies in the United States, which does most of its transport by truck. Buffett has justified the Burlington deal by citing competitive advantages over another of his subsidiaries, which on the surface doesn't make sense.

It is also clear that Buffett uncharacteristically stretched into the deal. His cardinal rules in recent years have been 1) don’t issue stock for an acquisition, 2) don’t issue debt for an acquisition, and, longest standing of all, 3) don’t split the stock. Well he broke all 3 rules for this deal, which I believe indicates how important it was to him and the company.

The deal, while certainly accretive to Berkshire's bottom line, is more important in how it will transform Berkshire into an easier to understand and manage operational company, rather than the quirky insurance company cum investment vehicle that it was before the deal. For decades analysts have wrangled and argued about what Berkshire is exactly – is it an insurance company? An operating company? A mutual fund? A conglomerate? A hedge fund? When the world's most brilliant investor is at the helm the answers probably don't matter, but when an unknown successor takes his place, as must happen eventually, they are paramount.

To take a step back, Berkshire has produced an enviable long term track record, but it is almost entirely due to the efforts of Buffett and his partner Charlie Munger. But Buffett is 79 years old, and his partner Charlie Munger is 86. Additionally, most of the CEO's of the operating subsidiaries are similarly "wise". Not to be morbid, but this entire collection of about 50 executives are unlikely to be running the company in just 5-10 years. Succession is a major issue not only at top but in the ranks, and while Buffett has stated that this is a major topic for the board, he has been somewhat coy in his communications on the matter. Anyone investing in Berkshire with a long-term view needs to consider exactly what succession means, because the succession plan will occur while they're holding the investment.

Buffett has mentioned a letter in his desk drawer that should be read upon his demise (no kidding), which will detail the succession plan. He has also dropped some hints about who in the organization might succeed him. But this barely scratches the surface in terms of answering questions about how the company would look – what responsibility will his successors have? Will they still make major deals? Will the company consider changing any of its long-standing policies such as paying a dividend or selling subsidiaries? These questions are all unanswered, and investors are simply expected to give Buffett the benefit of the doubt in resolving them "from the beyond".

Perhaps more than anything that Buffett has said or done about succession, I think that the Burlington deal answers many of these questions. It transforms Berkshire into a huge operating company, operating primarily in a business that is relatively easy to understand, rail transport. Berkshire will acquire a wide and deep bench of management talent at Burlington, and many of Berkshire's present managers in its transport and utility businesses are probably more compatible with this business than any of Berkshire's others. One of the front runners to succeed Buffett is David Sokol, who manages some of the utility businesses.

Berkshire has also suffered somewhat from the problem of being overcapitalized. The company has been piling up billions of dollars in cash for more than 10 years without sufficient avenues of investment. This extra cash has in a sense hurt Berkshire's returns since it sits around earning about 1% interest. It also provided a problem for succession, because anyone that inherited billions of dollars in cash is unlikely to make great decisions with it. The Burlington deal addresses this "problem" by first requiring all of Berkshire's extra cash for the deal, and also providing a sponge to absorb capital for the indefinite future – in a profitable fashion.

We have an investment in Berkshire that has done well over the past year or so, and I am looking forward to even brighter days ahead for this company.

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.

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