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Second Quarter 2010

Intro

The first quarter of 2010 was relatively quiet, though that changed abruptly in Q2. After a brief rally in May, the BP oil spill, problems with Greek and European debt, and other worries about the global economies put all pall on the markets which some called the "June swoon".

On May 6, the markets experienced what looks to have been some combination of a mini-correction and electronic trading errors. The Dow fell a record-breaking 1000 points in just a few hours, and bellwether Dow stocks like Proctor and Gamble briefly fell by more than 35%. Much of this ground was recovered, and later some investigation suggested that trading or computer errors were responsible for some parts of the decline. However this seemed to mark an abrupt end to the rally.

Then the BP oil spill gave everyone more to worry about. The spill itself is a terrible environmental and economic catastrophe, with effects that will be both profound and long lasting. While an oil spill in the Gulf of Mexico doesn't directly impact every stock on the market, the market took this opportunity to deflate from the rally earlier in the year. This decline provided a good opportunity for me to put more of our cash to work, which I'll detail a bit later.

Administrative Change Update

Last quarter I mentioned some problems that I was having transitioning to TD Ameritrade's new data platform. The difficulties were, to my pleasant surprise, fairly easily overcome, and I was able to update my statement processing software in just a couple of weeks. The Q1 statements were produced normally, and it looks like the Q2 statements will be slightly delayed but should also be produced without much of a problem.

As always, my goal with the statements is to give clients information above and beyond what is provided by TD Ameritrade that describes their investments and performance. If clients have any questions or concerns about their statements, please contact me at any time.

Top Holdings 3/31/2010

Holdings in individual accounts may vary from this composite, though I attempt to have each account mimic the composite as closely as possible.

Description	% of Portfolio
Cash and Equivalents	11.2%
Brookfield Asset Management	10.6%
Fairfax Financial	8.8%
Berkshire Hathaway	8.3%
Leucadia National	7.6%
The St. Joe Company	7.4%
Access National Corporation	7.3%
Acme United	6.8%
Brookfield Infrastructure Partners	5.6%
USG Corporation	5.4%
Mass Financial Corporation	5.2%
Western Sizzlin' Corporation	4.8%
The Washington Post Company	4.7%

Five of these ten holdings are what I call "wealth creation" companies – Brookfield Asset Management, Fairfax, Berkshire, Leucadia, and Mass Financial. These are companies engaged in numerous diverse business activities and/or with significant investment operations. While technically corporations, they are more akin to investment funds run by best-in-class investors.

I feel that these companies, run by some of the best wealth creators of our time, will navigate through the current difficult environment and take advantage of it by making new investments at excellent valuations.

Two New Investments

Throughout the market turmoil of the past 6-12 months, I have been on the lookout for good new investments, but have not found many that met my requirements of being good and cheap. When stocks began to fall and provide buying opportunities, I have been primarily adding to existing positions, which are stocks with which I am very familiar with solid long-term prospects. This changed during the second quarter and two new positions were opened.

Before naming names, let me mention again that I believe that the best investment opportunities are found in companies that are perceived to be distressed, and when there is a substantial difference between public opinion and economic fundamentals. Conversely, my worst mistakes have been when buying into companies surrounded a cheery consensus. Investors need to be cautious when buying into controversial situations, and are very likely to be rewarded negatively immediately after their initial purchase. Indeed, I would guess that a vast majority of the stocks that I've ever purchased have fallen significantly after purchasing them, though a majority of them went on to provide solid gains.

Citigroup

One of our new positions is in Citigroup, one of the largest financial institutions in the US. Citigroup got into trouble during the financial crisis, and accepted $25 billion in TARP funds, $20 billion of additional government assistance, and a government guarantee for $306 billion of its loans and securities. Citigroup's market value fell from $300 billion to a low of $6 billion in 2 years, and is now around $120 billion.

Citigroup's situation is interesting because they are still operating, have numerous valuable business segments that never stopped earning money, but got into serious trouble and would not be solvent without the help from the US government. The question for investors now is their future, not their past. After intense scrutiny from the US government as part of its support, Citi's troubles are fairly well understood at this point. The bad loans are "going through the snake", executives have been fired and punished, and new, higher quality assets are coming on the books. I believe the worst is past. Going forward, Citi is exploring various options for raising enough of its own capital to repay the government and move out of its influence. They intend on splitting the company into two parts in the near future.

I believe that the investment in Citi is compelling for a few reasons. For one, as is often the case after a crisis, Citi found religion in its lending practices, and began to adhere to very stringent standards. This was especially true because of the intense scrutiny from their new largest investor, the US Government. As a result, as the bad loans fall off the books, they are replaced with loans of much higher quality. Going forward, Citi's book of business should carry much better risk/reward.

Additionally, due to the recent problems, Citi booked enormous losses and has accumulated over $20 billion in tax assets, so if and when (I'm leaning more towards "when") they begin to earn substantial amounts of money again, it is unlikely that they'll pay taxes for quite a while. Finally, over $20 billion of capital is currently tied up supporting the wind down of certain troubled business units. I think that this capital will eventually get freed up and will be available to support Citi's business.

Aside from these special factors, Citi is an integral part of the US economy that, while in a rough patch now, is likely to recover and prosper, and Citi should prosper with it. This could become the beginning of a long cycle where Citi expands their business in a much more favorable economic climate, and I think that outcome will make the current stock price look very cheap in retrospect.

ATP Oil & Gas

The meltdown in oil and gas companies in the wake of the BP oil scandal produced many interesting investment opportunities. These investments carry some risk (as defined by the chance of permanent loss of capital), but also carry what I consider to be well above average reward.

Deep sea oil drilling is obviously a very unpopular business these days, especially in the Gulf of Mexico. The public and their politicians are outraged by the extent of the damage and the seeming inability to control the spill, and are calling for drastic action. However, oil remains an irreplaceable energy source for the US and the rest of the world, and the oil industry is also an irreplaceable source of jobs in certain regions. Indeed, even as the oil was gushing from the leak under the Gulf of Mexico, numerous local residents and business owners were still in favor of drilling in the Gulf because it was a major source of their sustenance. It is obvious that these projects will have to be done more carefully and with better precautions, but they still need to be done.

ATP Oil & Gas is a relatively new and small oil exploration company with relatively large drilling projects in the Gulf. As an up-and-comer, the company has much more execution risk than the majors, and is financed with a much larger percentage of debt. As a result, the down side if things go poorly is probably pretty bad, but the upside if they succeed is extraordinarily good.

Just prior to the BP spill, ATP refinanced some debt and pushed out the maturities, and has sufficient capital to support its projects. The drilling moratorium put in place after the BP spill will affect some of their projects, though one of their largest and most promising projects was allowed to proceed. After the spill and the moratorium, ATP's lenders continued to provide support in the form of increased lines of credit with longer maturities. So far, so good, as they say, and I am optimistic that ATP will navigate this difficult environment and become successful.

Other Updates

Following are some updates on existing positions.

Brookfield Asset Management

Brookfield Asset Management, one of our larger holdings, has a distinguished history of buying multi-billion dollar fixed assets on the cheap, by acting quickly and with scale during market crises. When the recent meltdown began to unfold, I was hoping that they would add another brass ring to their already impressive collection, and it seems like they have.

In August 2009 Brookfield set up consortium of investors with $5 billion with the intention of investing in distressed real estate. Using this entity they made a bid for General Growth, the second largest operator of shopping malls in the US. General Growth has unquestionably high quality assets, but got itself into trouble like so many others during the credit crisis, by failing to roll over otherwise manageable debt. Brookfield's beat out Simon Properties, one of General Growth's competitors, and the offer was approved on May 7. Brookfield will likely control the entity and this will be a source for cash flows, appreciation, and deal flow for many years to come.

Brookfield became a major player in the real estate markets in 1996 when it executed a similar transaction to gain control of Olympia & York, which included 3 of the 4 towers of the World Financial Center. Executing major transactions like this from distressed sellers is a major driver of Brookfield's shareholder value, and as shareholders we should all be very pleased with this result.

Sardar Biglari and Steak'n Shake

As mentioned in prior newsletters, a young activist hedge fund manager named Sardar Biglari has taken over a venerable restaurant chain named Steak'n Shake and intends on using it as an investment platform. This gained my attention because there is often value to be found in turning around established companies that have hit upon hard times but are fixable.

Biglari has done a good job of staunching the losses at Steak'n Shake, though he has also gone to some lengths to restructure the company in ways that have nothing to do with restaurant operations. For every dollar that he saves, he seems to be interested in paying himself three dollars for his trouble. While Biglari's actions have gained him a following among investors and the press, I view them with a large degree of caution, because a number of things that he has done raise red flags for me as a potential shareholder. However, I believe the transformed company is an excellent credit and I was eager to be a creditor to that company, and we got an opportunity to do so on very attractive terms in late 2009 through somewhat of a complicated transaction.

Western Sizzlin' is another small restaurant chain also controlled by Biglari. In late 2009, it was announced that these two companies would merge. Biglari was essentially buying out one company he controlled with another that he controlled. The terms for Steak'n Shake were poor, but the terms for Western Sizzlin' were very generous. Accordingly, I chose to buy stock in Western Sizzlin' in August of 2009 at approximately $14.20 per share.

To summarize a complex transaction, our shares in Western Sizzlin' where converted into a combination of equity and debt in Steak'n Shake. I had no interest in holding the stock portion, and was able to sell for a dear price soon after the transaction, booking a quick profit. The debt we continue to hold, and I consider it to be pretty secure, and attractive based on its yield.

The upshot is that, if we had invested $10,000 in Western Sizzlin' stock, we would have wound up with about $4,567 of stock which we sold for $6,112 and $5,600 worth of debt paying $630/year in interest, which will provide a yield of about 15.5% from our cost. So in essence we acquired a secure 15.5% yield, which I consider to be an attractive return.

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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