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Second Quarter 2011

Intro

The stock market was generally quiet in the first quarter of 2011, and Tidd Capital portfolios slightly outperformed during this time (6.1% vs. 5.8%). Stocks generally looked fully valued, and earnings reports were mostly in line with expectations. There were occasional concerns about the debt situation in Europe and some other global issues, offset by a generally positive economic climate in the US.

Market action in the second quarter turned soft, with a decline in May followed by weak trading in June. Companies in almost every industry saw declines, as concerns about Greece, commodity prices, the US housing market, and lackluster global economic growth ruled the headlines and sentiment.

The generally fully-valued and stagnant market in Q4 2010 and Q1 2011 led me to build our cash position to about 15% by selling fully-valued positions, and no suitable reinvestment opportunities could be found until just recently (more on that in a moment). This cash position insulated us somewhat from the declines in Q2, but generally we remain nearly fully invested in stocks and are susceptible to market volatility. I retain a positive long-term view of our investments and don't attempt to "step out of the way" of temporary market declines, since riding out the bumps has proven to be a better long-term strategy.

The global economies are not in the deep crisis mode of a few years ago, but are having trouble finding consistent growth without speed bumps. My return expectations in this environment are accordingly muted, most of our investments target returns in the 8-10% range with some potential upside from there if they develop favorably. I am seeking returns that are reliable and preferably in cash, with safety of principal the prime concern.

Portfolio Updates

Operationally, most of our investments have been progressing largely as expected despite the volatility in market prices. Brookfield Asset Management continues to grow in this environment by capitalizing on new deals and refinancing its assets to lock in lower rates. They now have a controlling stake in US mall operator General Growth Properties, and successfully refinanced some of that asset's debt at lower rates, which boosts their own cash flows. Their Brookfield Infrastructure Partnership (also held by us) is doing particularly well, reaping the benefits of recent large acquisitions.

Berkshire Hathaway has also increased its earnings power through acquisitions, agreeing to buy specialty chemical company Lubrizol in a sizable deal last year. The deal was marred by allegations of misconduct by one of Berkshire's executives that was involved in the deal, but it looks likely that the deal will close at the end of 2011 and give Berkshire a significant boost to earnings. At Berkshire, large deals are good news, because the invested cash almost always provides an immediate cash return on investment.

Berkshire continues to transform itself from a deal-making machine into an operating company, with more and more of its earnings coming from operating businesses rather than one-of-a-kind deals made by Buffett. This makes the company more profitable by typical measures and easier to understand and manage, which are all positive developments for Berkshire shareholders. Warren Buffett is 80 and his partner Charlie Munger is 87, so succession is a pressing issue. I thought that Berkshire stock was quite cheap at the end of 2010. The stock is slightly lower today, despite the increased earnings power, and represents an even better buy.

Access National Corporation (a small regional bank based in Reston, VA) continues to bang out 8-10% annual book value growth, having reported its 43rd consecutive quarterly profit in Q1 along with an increased dividend. The conservatively run bank operates in one of the country's strongest economies and is largely insulated from global economic turmoil. The reliable 8-10% returns might be considered boring in another climate, but are very welcome in the present one.

Leucadia National is involved in racy businesses such as mining, investment banking, and coal gasification. These businesses tend to be volatile, and are at the center of particularly "interesting" market action such as commodity prices, the ethics and profitability of investment banking, and global economic growth. Sentiment in these industries soured during Q2 and Leucadia's ~12% decline during the quarter reflected this. However, the managers at Leucadia have proven an uncanny ability to profit from their transactions, and I have the utmost confidence that they will continue to do so.

We invested in Citibank about a year ago, anticipating that the one-time earnings powerhouse would extract itself from government control and use its surplus capital position to expand in an improving economy. This thesis has yet to fully play out. It was looking good in the 2nd half of 2010, but global financial companies are still hamstrung by government intervention and are still negotiating and reaching settlements for the unwise business they did before the crisis. The US economy has yet to show robust growth. Citibank stock is still above our cost basis, but the 23% gain we enjoyed in Q4 2010 was mostly reversed in Q2 2011. It still looks early to invest in financial companies post-crisis, but I don't think it will be early forever. I have increased our investments elsewhere in the financial services sector, which I'll detail in a moment.

We entered our investment in ATP Oil & Gas during Q2 2010 in the aftermath of the Deepwater Horizon oil spill. Our cost is around $10 per share, a deeply discounted price which reflects the concern bordering on panic in that industry after the spill. ATP was facing significant but in my opinion surmountable issues from the drilling moratorium imposed after the spill. The panic eventually subsided, the drilling moratorium was lifted, and ATP not only resumed work on its wells in the Gulf of Mexico, but began expansion in Israel. Their liquidity and cash flows have improved, and they seem to be out of immediate danger. The stock soared to over $20 at the end of Q1 2011, but in the weak market action during Q2 2011 fell back to around $15. The overall 50% return in a year is certainly satisfactory, though the stock hurt our performance in Q2. I think more returns are in store for us as we continue to hold the stock.

Footstar

I have had a few questions about our investment in Footstar recently, and wanted to bring it back to light.

Footstar was a shoe retailer business controlled by K-Mart, yet independently run and with a separately traded stock. There were Footstar "stores within stores" in many K-Mart locations. Unfortunately for Footstar (but ultimately fortunate for us), the two companies got into an intractable dispute regarding their ongoing business arrangement. To make a very long story short, K-Mart and Footstar decided to terminate Footstar's business and put the company into liquidation, and pay Footstar shareholders dividends from the proceeds of its liquidation.

Warren Buffett popularized the term "cigar butt" for investments like this. A company might be unattractive for long-term investment, but in a situation like this, you are sometimes able to buy the stock at a price where the cash distributions you expect to receive over the next few years will exceed your cost basis, providing you with a profit. This is akin to finding a cigar butt on the street and taking a couple of puffs. It's kind of yucky, but the puffs are all “profit”. These situations are particularly attractive in a weak or volatile market since the liquidation is not correlated with market action.

We paid prices varying from about $4.50 to $5.10 per share for Footstar stock in April 2008. Since then, the company has paid $4.85 per share in distributions and as of June 30, the stock trades for $0.72 per share. So we are currently showing a small profit on the investment, with a current value of $5.57 compared to cost bases ranging from $4.50 to $5.10. This compares favorably to an S&P 500 that was down slightly during this time.

The fly in the ointment is that the stock no longer trades. Once the company embarked on the plan of liquidation, the stock stopped trading and brokerage back-office services stopped settling trades. So it simply isn’t possible to sell the stock at any price, and we are stuck with the stock while the story plays out. This is not usually a big problem in these situations, because the company pays cash distributions, and once the cash is paid, the profits have been made and the stock can simply be canceled as worthless.

A nuisance arises when a client has an account that is otherwise closed, but which holds shares of Footstar. The small position (in some cases less than $250) can’t be sold, yet is showing a profit, and the account can’t be closed until the stock is gone. I have talked with our broker TD Ameritrade about this several times over the past 18 months, and they are simply not trading the stock. Curiously, other brokers such as E*Trade will trade the stock, a situation that I have never seen before, where one broker will trade a US-listed security and others will not.

Clients who are "stuck" with this stock held in an otherwise empty account have two options. One is to wait until the company's new reorganization is finalized, at which point the stock should then trade normally. This is moving along and I expect something to be completed within a few months. The other option to to transfer the stock to a broker that trades it, such as E*Trade, and perform the transaction there. If you are interested in pursuing the second option, please contact me and I can help facilitate the transfer.

As a footnote, Footstar surprised the investing public by announcing in January 2011 that, instead of paying out the last of their cash in a final distribution, they would use it to acquire a small pharmaceutical company. The deal they struck appears to be pretty good, though at this point the stock represents about 0.5% of our portfolios and is not very meaningful (and we can't buy more of the stock to increase our exposure either). Because Footstar was in the 11th hour of a liquidation, it needs to change course and get its shareholders to approve an "un-liquidation" plan to restore it to an operating company. This involves having special meetings, sending proxies to shareholders, etc. In the meantime, the stock is stuck in limbo because it doesn't trade freely.

New Investments

Business development companies (BDC's) occupy an interesting and profitable niche in the financial services industry. These companies are "specialty lenders" that lend money to small businesses, often those that are going through some specific transaction such as a recapitalization or significant expansion. They lend money at rates appropriate for corporate credits with some risk, usually around 9-15% usually an equity interest, and often take an active role in managing the investments profitably.

The average leverage ratio of a typical bank is about 12 to 1 (i.e. twelve dollars of liabilities for every dollar of equity). In contrast, BDC's are limited by law to a ratio of 2 to 1, so they carry a maximum of 1/6th the leverage of the average bank. Their investments are more risky, but on balance, a well-run BDC is more profitable than a well-run bank.

Like REIT's, BDC's pay almost all of their earnings out as a dividend and tend to be high-yield stocks. Due to this and the lack of leverage, an investment in a BDC is closer to a direct investment in the corporate bond market than the stock market, something which I find attractive in the midst of a weak and volatile stock market. The yields meet our return requirements, and we have an opportunity for equity upside with each investment.

We have invested in many BDC's over the past 7 years, and generally have a very good track record with them, and I have learned what to look for and what to avoid. With the exception of a couple of losses taken during the financial crisis of 2008, we enjoyed dividend yields in the 8-14% range with some capital appreciation and total returns that handily beat the market.

The financial crisis and related liquidity crisis caused trouble for many BDC's, and after taking some lumps in 2008 I have avoided the sector until recently. Management teams at today's crop of BDC's are keenly aware of the recent past, and now structure their businesses much more safely. A crucial difference is that the primary source of capital is equity rather than debt. Equity can't be refinanced or canceled like debt financing. Lending standards are higher while rates are also high, which leads to investments that are safer and with higher yield than previously. Post-crisis, BDC's that are not saddled with troubled assets and had cash to invest in the aftermath are the most attractive, because their assets are generally of the highest quality and yield.

The first of the two new investments is PennantPark Investment Corp, which IPO'ed just as the crisis was taking hold in April 2007. Described as a "steady as she goes" BDC by analysts, PennantPark has a straightforward BDC business model, a solid management team, and have already put together a solid portfolio since IPO. Their expansion opportunities are bolstered by access to SBA debentures, which is cheap long-term debt provided by the small business administration. You may remember that Triangle Capital Corp, a BDC in which we invested successfully a few years ago, used a similar type of financing. PennantPark's current yield is 10%, which I expect to grow as they continue to grow their investment base.

The other new BDC is Horizon Technology Finance Corporation. Horizon is very new, having IPO'ed in December 2010, and is still investing its initial IPO cash. So far they have paid only two quarterly dividends. They also have a different focus than the typical BDC, investing in development-stage companies in the technology, life science, healthcare industries. In this way they are somewhat more of a venture capital fund than a BDC, but still obtain cash returns on investment.

I am interested in the exposure to the technology area, which is one of the stronger segments in today's weak market. Horizon's second dividend payment was 50% higher than its first. Based on the most recent dividend payment, the yield is 8.4%. As they deploy their capital, I think the dividend could increase another 20-30% within 12 months, which would make for a very attractive yield going forward.

Administrative

I have changed phone service providers and was unable to retain my office phone number, so please be aware that the new number is (571) 308-6881. For the time being I do not have a fax number -- running a "paperless office", I don't think I've received a fax in more than 2 years. If you need to send me documents quickly, please contact me, the easiest way is usually scan-and-email. My email address, physical address, and the address of the Tidd Capital web site has not changed. Please contact me with any questions about your investments.

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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