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First Quarter 2012

Intro

After a weak third and fourth quarter in 2011, stocks abruptly shook off the doldrums starting on the first day of 2012 and came roaring back to life.

In previous newsletters, I anticipated that when the market turned, our stocks would perform better than the broad market. Indeed, so far in 2012 this is the case. The table below shows our top 16 holdings as of the end of 2011, and their performance so far in 2012 (including dividends) compared to the S&P 500, ordered by performance (not by size of holding):

Company	Performance 2012 YTD
Bank of America Corp	+45%
Howard Hughes Corp	+42%
USG Corporation	+39%
Citigroup, Inc.	+30%
St. Joe Corp	+27%
Citizens Republic Bancorp, Inc.	+21%
Access National Corp.	+20%
Leucadia National Corp.	+19%
ATP Oil & Gas Corp.	+15%
Brookfield Asset Management, Inc.	+14%
Brookfield Office Properties, Inc.	+11%
Pennant Investment Corp.	+10%
S&P 500 Index	+9%
MFC Industrial, Ltd.	+8%
ACME United Corp.	+4%
Berkshire Hathaway Inc.	+4%
Horizon Technology Finance	+0%

As you can see, my prediction came through in spades, as 12 out of 16 stocks have outperformed the market. This is only a short period of time, but in my view, the market has finally come to its senses and these stocks are being priced more in line with their underlying values. It is also interesting to note that the most economically sensitive stocks increased the most. Stocks in the finance, real estate and housing markets were weakest over the past year or two and popped the most this year. Fortunately, that is where are our portfolios are focused.

Concerns about the European debt and Greek economic debt crises dominated the headlines for the 2nd half of 2011, but this bad news was suddenly forgotten at year-end like an unwelcome guest that finally left. This serves to once again reinforce my view that markets are fickle and emotional, and sound business fundamentals always eventually drive market performance.

Updates

Core holding **Brookfield Asset Management** essentially did more of the same in 2011, generating cash flows from its assets and buying and selling assets profitably, producing a total return of 14% and increasing its net asset value (NAV) to just over $40 per share. Brookfield is an economic machine with numerous tentacles in global asset businesses which I believe is extremely likely to produce returns in the 10-15% per year far into the future. Brookfield is also ideally positioned for an inflationary environment, something I think we will start to see before long. I find Brookfield's assessment of its own NAV to be a tad optimistic, but trading at $31 per share even after the gains in 2012 I think the stock is undervalued and has a great future.

Brookfield Asset Management is a parent company to a number of subsidiaries. We have held and currently hold some of these securities, which I don't consider core holdings but buy and sell them when I feel there is an opportunity. For example we bought units of **Brookfield Infrastructure Partners** in late 2008 and sold it 3 years later, more than doubling our money. During 2011 I took a small position in another subsidiary, **Brookfield Office Properties**. I don't think we'll do quite as well with this one but I expect some outsized gains.

Someone should call the management at **Access National Corporation** and tell them that there was a recession, because they don't seem to have received the memo. Access National is a small commercial bank located in my home county of Fairfax County, Virginia. The extremely well-run bank has quietly produced book value and earnings gains of 10-12% per year straight through the worst years of the crisis. In the most recent quarter, they reported a 17% increase in book value for 2011, their 46th consecutive quarterly profit, a 50% increase in earnings, and a dividend increase. We have held the stock for nearly 5 years, and there were times when the market ignored this excellent performance and the stock traded down. Fortunately and finally, the stock has traded up to a 5 year high and we are enjoying the benefits of this performance. Access National is a small bank in a big market and I believe has a long and profitable future in front of them.

A surprising laggard in both 2011 and the first part of 2012 is **Berkshire Hathaway**. Warren Buffett has done many things to significantly increase Berkshire's value over the past few years, but the market does not seem interested. Significant acquisitions were recently closed which added value, and Buffett made very profitable investments during the crisis, many of which came to fruition in 2011. A cloud hanging over the stock is the succession issue, which only gets more significant every year. Buffett is 82, and his partner Charlie Munger is 88, and they still run the company, through statistically they won't be running it in just a few years. Buffett continues to be coy about the succession issue, and clearly intends on running the company until he goes to the big boardroom in the sky. The market is obviously worried about this uncertainty, and won't bid the stock up. My view is that Berkshire is an economic powerhouse that will not produce returns in line with the past, but is currently undervalued, even taking Buffett out of the equation. When Buffett does depart, my guess is that the company will offer to buy back stock from anyone that wants to sell, which should protect shareholders from a big drop in price.

We have small positions in **Bank of America** and **Citigroup**. Both are large banks with large problems, though I feel the problems are solvable, especially against the backdrop of an improving economy. Just six months ago, many were talking seriously about Bank of America going out of business, but that talk is largely over. With over *$2 trillion* in assets, Bank of America is not just a bank but part of the fabric of the US economy. The clouds hanging over the stock include liabilities from not only participating in the meltdown in the housing market and broad economy, but making two disastrous acquisitions (Countrywide and Merrill Lynch). They are exposed to billions of dollars of bad loans, mortgage fraud, European debt, and it isn't just the liabilities, but the fact that it is difficult to even determine how large they are.

All of that said, if just half of Bank of America's assets are earning assets, and they earn a modest 1% on them, that alone is $10 billion in earnings power compared to a market cap of $86 billion (even after the 45% gain in 2012). I believe that the bank's problems will reach resolution over the next year or two and the stock will begin to recover.

ATP Oil & Gas is our one foray into the racy oil exploration business, and the stock continues to be "interesting". The game plan at ATP was to make one well in the Gulf of Mexico productive, and use those proceeds to finance several other wells. This kind of plan could lead to huge upside if it works, and potentially huge downside or a complete wipeout if it fails. This investment carries more risk than is usual for us, but I felt it was a good opportunity that fit into the overall portfolio.

ATP had itself financed up to its eyeballs when the BP oil well disaster struck, closing $1.5 billion in bonds literally the day before the accident. I invested in the stock then, gambling that they would be able to pull through and get more wells online. They did indeed survive the BP crisis, but it has been a roller coaster since then. They succeeded in starting a new well off of the coast of Israel, though that won't be productive for probably a couple of years. Production from their existing wells has been uneven, with some delays and costs, though they had a positive breakthrough at a new well just a couple of weeks ago. They have succeeded in improving their liquidity position, but are still strapped for cash. I'm constantly evaluating this investment, and on the backdrop of the rest of our portfolio doing so well am more tolerant of the risk, but plausible downside scenarios remain.

Closing

It is a relief to see the market finally come to its senses, and for us to enjoy the benefits of the economic value being created by our investments. The US economy is not completely out of the woods yet. Job growth is finally underway, and the housing market is showing some signs of life in selected markets. I don't think the economy will really be on track until there is a broad housing recovery. However, most of our companies have quietly been building economic value even during the downturn, and I feel that we will continue to see these benefits in upcoming quarters.

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