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Third Quarter 2012

Intro

Throughout 2012 the economy has in my opinion continued to improve as key indicators such as jobless claims, corporate profitability and housing prices slowly improved. The summer was full of headlines about the European and Greek debt crises which raise the specter of a prolonged crisis or perhaps a second global recession, and the European economies are still struggling and on the brink of a second recession. However, these problems do not eclipse the strength of the US economy which overall I believe is doing well - not as well as 6 years ago, but much, much better than 3 years ago.

Our investment strategy coming out of the 2008 crisis was to remain fully invested, with about 40% of our portfolio in diversified core holdings such as Brookfield Asset Management and Berkshire Hathaway, with the remainder in economically sensitive companies (primarily in the financial sector) that stood to receive outsized benefits from an improving economy. As you can see from the table below, this investment thesis is generally playing out well:

Company	Performance 2012 Q3 YTD (Including Dividends)
USG Corporation	+116%
Citizens Republic Bancorp, Inc.	+70%
Howard Hughes Corp	+61%
Bank of America Corp	+59%
Access National Corp.	+55%
St. Joe Corp	+33%
Brookfield Asset Management, Inc.	+26%
ACME United Corp.	+24%
Citigroup, Inc.	+24%
MFC Industrial, Ltd.	+19%
Berkshire Hathaway Inc.	+16%
S&P 500 Index	+16%
Brookfield Office Properties, Inc.	+9%
Pennant Investment Corp.	+8%
Leucadia National Corp.	0%
ATP Oil & Gas Corp.	-98%

The fly in the ointment is obviously the last entry in that table, ATP Oil & Gas, which I will discuss in detail below, along with other portfolio updates.

Updates

First, the bad news. ATP Oil & Gas Corp. is a diversified oil and gas exploration company that we first invested in after the Deepwater oil spill in April 2010. ATP had nothing to do with the oil spill (the rig that caused the spill was owned by BP), but the spill put a hiatus on all drilling activity in the area and thus ATP was directly affected. Amazingly, ATP had just the day before the spill closed on $1.5 billion of financing and was planning on using the financing to more than double their production volume. The question at the time was if they would be able to execute on their drilling program in the face of problems created by the spill.

At the time, our investment seemed like a reasonable bet because while there was definitely a chance of downside, the upside would have been substantial, and I thought that ATP had several things in their favor. They already had productive wells and a good track record of successful exploration, and the financing would allow them to expand their operations. Additionally, with the economy emerging from recession, I hoped that oil prices would firm up and remain high which would provide them with solid cash flows from their production.

Unfortunately, things did not work out. They say that companies that fail don't run out of money, they run out of cash, which is what happened to ATP. The moratorium on drilling in the Gulf lasted much longer than they or anyone expected, which put a major crimp in their expected cash flows from the wells that were the core of their production. They were forced to mortgage their forward production to raise cash, and try to get other wells going quickly to generate cash. It became a footrace as the company tried to keep ahead of their creditors, but they unfortunately succumbed and went into bankruptcy. This likely means a total loss in our investment.

As I mentioned in earlier newsletters, ATP was an unusual investment for us, in that I could certainly envision downside scenarios that would cause a loss in our investment. My usual approach is to only invest when I am pretty certain that we won't lose any money. However, in this case, I felt that the potential upside and generally soundness of the portfolio justified this one riskier position. Obviously, we would all have been better off if I'd taken a pass on this one.

Fortunately, the news is better in virtually all other positions in the portfolio. Top performer USG Corporation is driven by the US residential housing market, and its more than 100% gain year-to-date reflects the long-awaited recovery that is finally occurring there. The housing market is a major driver of the US economy, and a recovery in the US housing market will solidify the recovery in the broader economy. USG stock tends to be a leading indicator of the housing market. It was one of the first stocks to fall when the crisis first occurred, and is now one of the strongest performers during the recovery.

We first invested in Citizens Republic Bancorp in July and August 2011 at prices ranging from $6.63 to $9.14. At the time, the bank had put some problems with bad assets behind them and had just turned the corner into profitability. In one of those fortunate quirks that sometimes happens in the markets, even though their financial results were clearly excellent and improving, the stock market bid down their stock price, making it an easy buy. The company went on to further improve their operations and solidify their results, and for icing on the cake, decided to put themselves up for sale.

In September, they agreed to be acquired by competitor FirstMerit for $22.50 per share, nearly three times our cost basis. We will be happily exiting this position. In the future, I will wait for opportunities like this rather than chasing risky companies like ATP.

It was less than a year ago that some analysts were calling for the demise of Bank of America, a bank with over $2 trillion in assets. There were concerns over its liabilities from bad loans and two large, troubled acquisitions (Countrywide and Merrill Lynch). However, it is becoming clear that that pessimism was overblown, and the company is settling its issues one by one. The bank's earnings power is coming more into focus as investors can overlook the clouds hanging over the company, and this explains the 59% gain in 2012. I think the stock has a ways to go before the company is fairly valued and we'll be holding on to our position.

The stock price of long-time holding Access National hit an all-time high in June 2012. The company's slow-and-steady business model while operating in one of the country's strongest regional economies has provided excellent results. We have begun to trim our position in Access National as its valuation has begun to get quite high, though we will still retain some ownership.

Acme United is a manufacturer of cutlery, scissors, school supplies, and first aid kits. This is a very long time holding of our portfolios, we have held the stock for more than 5 years. Unfortunately it has been a disappointing performer, despite strong underlying fundamentals and achieving what I consider to be significant expansion in its business. They have assembled a portfolio of niche products that dominate their markets. For example, the next time you are in Staples, look at the scissor and ruler products, and you'll find that 100% of them are Acme's "Westcott" brand. The dividend has increased 250% from $0.02 per quarter in 2004 to $0.07 per quarter in 2012, even though the stock price has been flat. Finally in just the past few weeks, the stock has begun to move up. However, I think the stock is significantly undervalued and we will retain our position.

MFC Industrial is the shape-shifting investment vehicle of financier Michael Smith. The company has changed names, countries of origin, and stock symbols, but always follows roughly the same investment thesis - using its equity capital to invest in merchant banking, commodities and mining. Currently MFC is expanding its commodities business through acquisitions. The stock is up 19% year-to-date, but I don't think this reflects the value of its increased business. We will be increasing our position in MFC.

Closing

I believe the foundation of the post-recession economy is taking shape. No longer are we staring into the abyss of a collapsed financial system or global lack of liquidity. The government no longer needs to bail out huge companies that are cornerstones of the economy. Some global economies are still in recession, and problems in the European economy look difficult to solve. However, it is clear to me that the worst of this historical period is behind us. Our portfolios are moving up strongly and we have ample cash to invest, but valuations are generally cheap. This is a great time to be an investor.

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