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Fourth Quarter 2013

Intro

The market finished strong in 2013, with the S&P 500 recording its best year in 16 years with a gain of over 30% including dividends. These gains represented not only solid performance for this 12 month period, but a new all-time high. Back in October 2007 at the peak of what we now know was a "bubble", the S&P 500 peaked at 1561.80. That mark was surpassed in April 2013 and the S&P finished more than 18% higher than that at the end of the year. So as far as the market is concerned, the "great recession" is truly history.

Is the market really worth 18% more than it was at at a bubble just 6 and a half years ago? Despite improvements, unemployment levels are still elevated, and the economy is being supported by the Fed's quantitative easing program and artificially low interest rates. Much of the gains of the past couple of years have come from "multiple expansion". If a stock goes from trading at a P/E of 12 to a P/E of 18, that is a 50% gain in market value even though the company is not making any more money. The difference is due solely to a change in investor's perception of the company's future prospects. The same metric can be used for the market as a whole, and when investors develop a favorable outlook, market values increase faster than earnings. These are all reasons to be somewhat skeptical and cautious.

Sir John Templeton said that, “Bull markets are born on pessimism, grown on skepticism, mature on optimism, and die on euphoria.” The key to investing successfully is to buy near the beginning of this cycle and sell before the end. Or as Buffett has often said, to be greedy when others are fearful, and fearful when others are greedy. Those of us who have been following the market for the past few years can see that we're certainly moving through these stages, as market sentiment continues to turn more and more optimistic. I don’t think the market is quite greedy yet, but it certainly isn’t fearful.

Based on valuations of individual companies and the market as a whole, I don't believe that we are in a euphoric stage of the market, despite recent gains. The market and most stocks in it seem to be approximately fairly valued, which is to say that there are few bargains but also few over-valuations. There is nothing wrong with holding fairly valued stocks, especially those that continue to increase their value as our investments do. There is danger in a highly valued market, but I don’t think we’re there (yet).

We started the year at approximately 11% cash and after receiving some dividends and the proceeds from some sales, we are now at about 18%. This relatively high level of cash reflects both the dearth of new investment opportunities as well as my cautious outlook in the face of strong market gains. I have several areas of the market I'm considering for new investments, including technology and energy, though there have not been any opportunities that provide attractive valuations. I will remain focused on this and hope to put our cash to work shortly.

In the face of all of this, our portfolios did not change much during 2013. We initiated a significant new position in Apple in March 2013 which has done pretty well. Our other major positions remained unchanged throughout the year, and generally did well, though many of them were not able to keep up with the S&P 500's blistering pace:

Investment (in descending order of portfolio weighting)	2013 Performance Including Dividends
Cash	0.0%
Berkshire Hathaway	27.2%
Brookfield Asset Management	6.6%
Access National	13.7%
Howard Hughes Corporation	61.0%
Bank of America	29.8%
Leucadia Corporation	18.1%
Apple Inc. *	33.2%
Acme United	33.2%
Sears Holdings **	21.2%
MFC Industrial	-5.6%

* Position initiated during 2013
** Position sold during 2013

One year's performance is not a complete picture, since longer periods are what matter, but it is interesting to see how individual investments performed during a hot market. The greatest detractor from our performance relative to the market was actually our cash position, though having cash available to take advantage of market opportunities is of paramount importance. And obviously, cash will outperform the market during market downturns.

Brookfield Asset Management was our most substantial non-cash laggard. The performance of MFC Industrial was worse than Brookfield, but it is a much smaller position and so had a much smaller overall impact. I will discuss individual positions in a moment, but I should mention that there is nothing about Brookfield's business performance in 2013 that is problematic even though the stock lagged. The business advanced substantially during the year as it used favorable market conditions to realize many gains and establish new subsidiaries and funds. Brookfield stock has outperformed the S&P over the past 5, 10, and 20 years, and I expect that it will do so in the future, despite lagging in 2013.

It has been a pleasure to watch our investments perform well this year with little or no effort on our part besides to read the positive news. Charlie Munger calls this "sit on your ass investing" and it is definitely my favorite way to invest! The updates for individual companies are generally of the "more of the same" variety, but I'll try to provide interesting highlights.

Berkshire Hathaway

Berkshire has enjoyed recovery and expansion across virtually all of its business lines. The housing related businesses have done the poorest over the past few years but they have begun to come around. The opportunistic investments that Buffett made during the crisis, providing badly-needed capital to GE, Goldman Sachs, Mars, Bank of America and others are coming to fruition, providing billions of profit for the benefit of Berkshire shareholders. Burlington Northern Railroad has performed well ahead of expectations and providing substantial profits. Buffett continues to find places to invest large sums of money and those returns will benefit us for years to come.

The primary risk with Berkshire is Buffett himself, who is now 83 years old and unfortunately won't be able to swing deals forever. The board at Berkshire is fully aware of the succession issue and I feel that they have planned accordingly, and I intend to keep holding Berkshire stock for the long term.

Brookfield Asset Management

Though Brookfield stock was a laggard in 2013, it is the one company I am the most excited about over the next few years. Brookfield deals in hard assets such as commercial real estate, power generation, and infrastructure, and I feel that these assets are poised for very positive returns over the next few years. They also make substantial use of fixed-rate financing and have been locking in low interest rates over the past several years. Inflation is probably in the cards for the global economies at some point, but I think this trend will be in Brookfield's favor since they own and manage real assets in key locations around the world. They have maintained excellent liquidity and stability throughout the crisis which has allowed them to close numerous deals to expand their business in preparation for the next market upswing.

Access National

Access National had a solid 2013, though generally I don't think they have growth prospects that would allow them to grow much more than 10-14% per year. So when the market is very hot it is likely to outperform this company, but a lot of wealth can be generated steadily compounding at 10-14%. Management is very conservative and cautious, which served us very well throughout the crisis, but they are not an aggressive growth company. At the end of 2013 they declared a special $0.70 per share dividend (approximately 4.6% of market value at the time), reflecting a surplus of capital they have accumulated due to excellent profits and limited problems. Access National's dividend has increased tenfold from $0.01/share in November 2010 to $0.10/share today, reflecting management's commitment to shareholders. After weathering the crisis it seems that management prefers stability and dividend yield to growth and risk, a tradeoff I can certainly appreciate.

Sears Holdings

We exited our position in Sears in December 2013. This investment was not as successful as I had hoped when I initiated it in November 2012. Sears' operations have been struggling for years, but the company occupies a key location in shopping malls around the US and Canada, and owns or controls this real estate at very low cost. I felt that the company would be able to stabilize its operations and begin to monetize these assets in some way. Sears also has substantial pension liabilities based on its commitment to current and former employees. I thought that they would be able to make some progress in mitigating this liability by providing buyouts to employees and other such deals.

Unfortunately the company has disappointed on all fronts. In 2013 the company's operations continued to report losses and burn cash at a rate exceeding my estimates. Time is the friend of a great business, but time is most certainly the enemy of the poor business, and as more time passes without progress, Sears finds itself deeper in a hole. Even as the US economy has recovered, Sears results have not, which is yet another warning sign. The stock did rally through 2013 and I took advantage of this to exit our position, and will look for better places to invest these funds.

MFC Industrial

Michael Smith's MFC Industrial had a fairly tepid year in 2013. The company has background in merchant banking, real estate, and takeovers, but did not succeed in expanding their business very much in 2013. Currently the company is full of untapped potential, with surplus liquidity and experienced wealth-creating management at the helm, but they have not been able to land deals. The stock is also trading at a substantial discount to book value. For these reasons we continue to hold it despite the poor performance.

The company's largest shareholder, consisting of various entities controlled by Peter Kellogg, is also dissatisfied with the company's performance and began to rattle Michael Smith's cage by engaging in an activist shareholder campaign. You may have received some of the correspondence, with rather colorful pictures and language on both sides of the "discussion". While I believe a lot of this is just posturing, Kellogg has legitimate reasons to push for better returns, and I am happy to watch the spectacle from the sidelines. Sometimes successful deal making does not happen on the schedule that you prefer, and I'm willing to continue to be patient with MFC to see how it develops.

Closing

I hope that this newsletter has provided you better insight into our investments. If you have any questions, please don't hesitate to contact me.

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