3rd Quarter 2012 Investment Review

Investment Thoughts

"Some managements tout their stocks and really try to encourage people to invest. We don't do that...our job is to manage the business, not the stock...the business is doing great and gaining market share, but we've also been very candid that growth rates do decelerate over time for any company now this big...when a business gets to be the size of our business, it's very, very hard mathematically to maintain high growth rates."

Jeffrey Boyd, CEO, Priceline.com, quoted in Fortune magazine September 24, 2012

There are ***exactly three*** things that matter when selecting common stocks for investment. First, the quality of the business; second, the people managing the business; third, the price you pay to participate. Everything else is secondary or irrelevant. The pleasant outcome when ***all three*** line up in our favor? The risk of ***permanent loss*** is reduced. Remember there are ***two*** views of ***risk***. The popular view of risk is the daily market fluctuations endlessly discussed by the talking heads on CNBC, Fox Business and Bloomberg: "the Dow's down 200 points today" or "the market has dropped 8% this year". That, my friends is STMD: ***short-term market decline***. Our definition of risk is ***permanent loss*** of capital due to bankruptcy, loss of market share or business impairment. Investing entails uncertainty but the probabilities of success are increased when we invest in a great business at a bargain price, run by capable managers with ownership stakes. Let's now look at some aspects of management.

I'm guessing you've seen the Priceline.com commercials featuring William Shatner starring as the "Negotiator". I don't use Priceline.com but I love the commercials. So do many other viewers. Business has boomed over the past 6 years. The common stock has also boomed, up twenty times over this period (and Shatner's net worth has boomed as he reportedly took some stock for compensation).

Unfortunately the candid quote by Priceline CEO Boyd is a rarity in the investment world. Corporate managers are agents hired by stockholders, and in a perfect world all corporate executives would say exactly what they are thinking. As Boyd says, some managements—I'd say a majority—practice some degree of stock promotion. Often the rosy scenario is promoted and potential negatives don't get mentioned unless it's obvious and requires disclosure. So, when I hear candid comments from managers I pay attention because it's as rare as the Chicago White Sox winning the World Series or Donald Trump having a "good hair day". Truly rare.

CEO Boyd is attempting to give investors a balanced assessment about the growth challenges that arise as a business becomes larger. Priceline has grown during the past 6 years from roughly $1 billion in sales to over $5 billion. Optimistic investors tend to project past growth rates far into the future, often pushing company valuations sky-high and creating the potential for significant stock price declines if expected growth doesn't happen. And guess what? In our competitive economy high growth expectations have a way of not happening. Plunging stock prices result.

The lesson is to avoid excessive optimism. Instead we seek "temporary" pessimism, when short-term fears create an opportunity to invest in a business at a discount to true value. This discount creates a ***"margin of safety"*** in case we are wrong and the business performs below expectations. We lose less or not at all. So, while Priceline's ***past*** has been very profitable, I'd guess life might get tougher and less profitable in the ***future***. Online commerce is very competitive and success far from assured.

While I admire the honest, frank manner of Priceline's CEO, the business doesn't have a strong, defensible advantage and the valuation is too rich for me. The key takeaway is good managers are important, but it's only one aspect and we need ***all three*** to play: business, people and price. When we have all three the chance of permanent loss is lower, and avoiding losses is the key to successful long-term gains.

"Prediction is very difficult, especially about the future." Niels Bohr, Physicist (1885-1962)

Now it's time to pick on Wall Street. In January 2012 thirteen of Wall Street's highly-compensated "strategists" revealed their forecasts for 2012 stock market returns. The average called for a 6.1% return. As is often the case, so far they are off base by a fair bit. As I write this the S&P 500 has exceeded all but one strategist's forecast. As Mr. Bohr reminds us predicting the future is a difficult business. So why bother? Indeed, we don't rely on predictions, forecasts, crystal gazing, fortune-telling, horoscopes, palmistry, soothsaying or Ouija boards to make decisions. Not really a "high-probability" way to assure a good outcome. Instead we focus on the "here and now" by analyzing ***"past and current"*** business conditions and let the high-priced strategists play the prediction game.

AISLE PASS ON THIS

An important part of our investment philosophy is to define what we ***won't*** invest in. Why bother with things we won't invest in? According to Bloomberg there are 15,000 publicly-traded companies in the U.S. You'll be quickly overwhelmed without narrowing your focus. Warren Buffett calls it "defining your circle of competence." When we understand the attributes of a less-profitable industry (airlines anyone?) it provides stark contrast to the really great businesses that we seek. So the ***study of failure*** is an important part of our research. This ***"won't invest"*** list is longer than you might think. Being highly selective is part of Triad's philosophy and success. Indeed of the 15,000 U.S. public companies we exclude roughly 98%, leaving 2% of the crème de la crème for intensive analysis. So there is plenty of "failure" to be reviewed and rejected. For example, I ***generally*** but not exclusively avoid the retail industry. It's loaded with companies in which we won't invest your hard-earned dollars.

Why avoid most retailers? Well, it's nearly impossible to attain a ***sustainable competitive advantage*** in the retail industry. That's Harvard Business School-speak for having an unassailable industry position that results in above-average profitability. Think Coca-Cola or Google. In retail, advantaged companies include Costco, McDonald's, T.J. Maxx, Starbucks, Coach and Tiffany. However these are the rare exceptions. Typically a retailer experiences success, competitors march into stores, copy successful methods and hire away employees. Also, new forms of distribution arise, changing shopper buying patterns. Main Street shops give way to big box retailers like Staples or Best Buy. Big boxes yield ground to online competitors such as Amazon.com. Or Wal-Mart, Costco and Target decide to expand their food offerings, and eventually it creates pain for traditional grocery stores like Safeway, Albertsons or Kroger. Also, unlike Coca-Cola it's often difficult to export a retail concept overseas due to societal or cultural differences, so eventually many U.S.-based retailers run out of room to expand.

It's a tough business. I liken retailers on the wrong end of things to lobsters in a pot being slowly boiled until dinner time. It takes years or decades in some cases, but the competitive outlook for many retailers is uncertain at best. We are highly selective but even more so with retailers. I follow the saying on Missouri State license plates: Show Me. We don't want to be the lobster in the pot.

Economic Conditions

The global meltdown continues to be averted. Europe hasn't imploded but is facing recession. China's economy continues to slow, impacting U.S. exports and global growth. In the U.S. the fiscal cliff of automatic spending cuts and tax increases come January 1, 2013 isn't looking quite so dire, although I have a healthy respect for politicians' ability to push us to and perhaps over the cliff. My guess is the worst outcome will be avoided and some progress will occur after the elections.

Meanwhile, our economy displays signs of strength (housing, auto sales, personal finances) and weakness, most notably in jobs. The Federal Bank of Bernanke continues to shovel dollars out for all to spend. We don't place our bets on economic forecasts but the environment seems reasonable enough for our participation.

Investment Conditions

Stock prices have increased throughout the year, and ***bargains are less plentiful*** now than was the case a year ago. Fortunately we don't need 100 or more investments. I need to find a few good opportunities among hundreds of potential options. I believe our current portfolio has better potential than the overall stock market as represented by the S&P 500 or the Dow Jones Industrial Average. If and when prices reach valuations that don't justify our participation, then we'll reduce exposure and wait for better conditions. It's important to understand this because one day we'll be there.

Our portfolios have benefited greatly this year from our ***focus on previously unloved areas*** including housing and financial services companies. Investors finally realize that housing is on the mend. Our housing and related investments--cement, drywall, air conditioning, appliances--have seen significant stock price gains this year. I have trimmed the positions as prices have increased but the price gains have offset the stock sales, leaving the commitment still around 25-30% of common stocks. The good news is the housing rebound is just getting started and the outlook over the next 2 to 3 years is favorable. In addition, we own excellent companies with committed managers holding substantial ownership positions.

Bonds remain unattractive with rock bottom rates offering little return and substantial risk as interest rates rise. And rise they will. High yield bonds offer selective opportunities but much fewer than 1 to 2 years ago. Ditto convertible bonds, where stock market gains have raised prices and reduced the return potential.

As we approach year-end I realize taxes are a concern for most clients. I will endeavor to realize additional capital gains between now and year-end only where there is strong investment rationale to do so. But taxes won't dictate decisions.

Let me know if you'd like a copy of our SEC Form ADV Part II. And please let me know of any changes to your financial situation that might suggest altering your current investment portfolio.

I remain confident in our philosophy and investment process, believing we have the opportunity for respectable investment returns over the next 3 to 5 years. I encourage comments, questions and suggestions, and I appreciate your loyalty and patience.

Sincerely,

John Heldman, CFA
October 29, 2012

"Always do right. This will gratify some people, and astonish the rest." Mark Twain