TRIAD
INVESTMENT MANAGEMENT

4th Quarter 2012 Investment Review

Investment Thoughts

"We don't pay any attention to investment banks or brokers. It's not an efficient use of our time to read their reports. We read hundreds and hundreds of annual reports every year."

Warren Buffett

I recently bumped into a longtime business acquaintance at Starbucks. Knowing I manage money he blurted out the latest stock he was buying. I had a vague recollection of the company, but couldn't bless his purchase. "Do you watch CNBC?" he asked. "No" I replied. "What do you do then?" he inquired. "Well, I read corporate annual reports and SEC filings." "You know, 10-K's, 10-Q's, that sort of thing." "But that's boring!" was his reply. "Boring but profitable" I offered. I departed pondering the behavioral tendencies of investors. Watching CNBC, Fox Business or Bloomberg Television might be entertaining, but it's a terrible waste of time if you're looking for investment information. As Warren says, reading is much better. My friend mentioned receiving research reports from a large brokerage firm, apparently thinking this gave him an advantage. Unlikely. Watching financial TV and reading Wall Street brokerage reports is a sure route to investment mediocrity, if not worse. While the TV watchers are "entertained" we are engaged in the rational study of businesses, the people who run them, and assessing bargain valuation levels.

"Talent is God given. Be humble. Fame is man-given. Be grateful. Conceit is self-given. Be careful."

John Wooden, UCLA Basketball Coach, Author, 1910-2010

Let's now consider what seems to be an epidemic sweeping the nation. It's January and the flu has hit epidemic levels this season, but we're not talking about the flu. No, we are talking about the epidemic of cheating. It seems to be rampant in the world.

Lance Armstrong was recently interviewed by Oprah Winfrey. I watched the interview, despite not being a cycling fan. I'm more interested in the behavioral aspects of Mr. Armstrong. I'd read an extensive Wall Street Journal article a few years ago about doping in cycling. After finishing the story I thought "this guy and just about everyone else in cycling is guilty of using banned substances". The evidence seemed overwhelming.

Why did he do it? "Arrogance and a feeling of invincibility" suggested Lance. Would he have been successful had he not cheated? Yes, but he acknowledged he wouldn't have won 7 straight Tour de France events. It was his obsession to be numero uno, to be on top, which drove him to cheat on a massive scale, and cover it up for years. The financial rewards were probably a significant motivating factor as well. Now he faces years of litigation and uncertainty. He tried to exchange success for the pinnacle of success and lost his way.

What does this have to do with investing? Well, we have some parallels in the investing world. Many of our competitors, notably hedge funds, find themselves being investigated by the federal government for various forms of cheating. Newspapers are full of articles about this or that trader, research analyst, fund manager or business insider being indicted or pleading guilty and cooperating. Uncle Sam's track record looks pretty good, with a very high conviction rate. Most cases are insider trading, where one party obtains "material, non-public" information that is used to profit from trading in a stock or other security. Many of these people are already extremely well-compensated, with much to lose from their illegal activities. And yet, they do it anyway. Like Lance Armstrong, what were they thinking?

Envy, Greed, and Gluttony are several of the original Seven Deadly Sins that trip up many an athlete, businessperson or investor. It's instructive to observe the mistakes of others and remind ourselves that pushing for too much--in sports, business or investing--can turn a comfortable existence into professional, financial and personal purgatory. What is most perplexing is that many of these top performers don't need to cheat to achieve success. To paraphrase Charlie Munger, ***"why risk what you have to pursue that which you don't need?"*** And that's the lesson. As Coach Wooden counsels, ***"Conceit is self-given. Be careful."*** When you think you have the world mastered, you are most vulnerable to self-delusion. At Triad, we think about this. Constantly.

Economic Conditions

While we make a practice of not practicing economic forecasting, we do spend time observing ***current*** economic conditions. And things are looking better lately. Specifically, home sales and prices continue to increase, creating new jobs and making consumers feel better about their household wealth. Rock bottom interest rates continue to thaw the previously frozen lending world, providing further ammunition for better home sales over the next several years. And stronger home sales lead to additional purchases of appliances, carpet, furniture, etc. Further, automobile sales are reasonably good, and the continuing boom in domestic oil and natural gas production will provide multiple benefits over the next 5 to 10 years. Reduced energy imports lower our trade deficit and energy costs, improve national security, and create millions of jobs in energy production. It's such a big deal that companies are relocating manufacturing facilities to the U.S. because lower energy costs improve the competitiveness of manufacturers, particularly the chemical and steel industries.

While the U.S. private sector has been improving its efficiency since the global meltdown four years ago, the public sector has absorbed much damage, with government spending surging and budget deficits still at unsustainable levels. Washington, D.C. still appears dysfunctional to the average citizen. Should real compromise and progress be obtained from our politicians, it could be a real surprise how much better conditions could be.

Investment Conditions

Our composite equity returns for 2012 were 46% while the S&P 500 returned 16%. We had a very good year, but ***bargains are less plentiful*** now. Fortunately we need only a few good ideas among hundreds of potential options. And, ***I believe our current portfolio has better potential than the overall stock market***. However, if market prices approach our long-term targets, we'll sell and wait for better opportunities. It's important to understand this because ***it will happen one day***. We may find ourselves with a portion of assets in cash reserves while the stock market party continues. You might feel uncomfortable, even a bit envious that others are making more money. It's perfectly understandable and human to feel this way. Remember Greed and Envy? Once we understand these feelings we can rationally choose to ignore them. To repeat Coach Wooden, ***"be humble and be careful."***

Our portfolios benefited last year from investors' late arrival to the housing rebound. We showed up at the party early (2009-2011) and are now looking for the exit sign. It's getting later in the night and some of the party-goers are dancing on the tables and wearing lampshades on their heads. Late arrivals to the party are now paying a high price for admission. So we have reduced our housing exposure somewhat. Housing and related areas were roughly 28-30% of our stock holdings during the second half of 2012. After making sales during 2012, we finished the year with roughly 24% in housing and related stocks. If prices climb further this year, our expectation is to make additional sales, while looking for other areas suffering from investor anxiety. Remember, ***we make our living by "buying fear" and "selling greed."*** It's one of the most important tools in our bag of tricks.

With the recent reduction in housing investments, ***our largest common stock concentration is now in financial companies***, the heretofore pariahs of the investment world. We have roughly 30% invested in a variety of financial companies, including commercial banks, investment banks, custody banks and insurance companies. Financial companies have been uniformly despised by taxpayers and investors (remember the Occupy Wall Street movement?) for contributing mightily to the financial crisis and getting bailed out by the Feds. Fortunately for us, investors have thrown out the baby with the bath water, branding nearly all financial companies as societal and investment misfits. This ***"herd mentality"*** of negativism has given us the opportunity to acquire a high-quality group of financial services companies that we can hold for several years as we await more optimistic investor sentiment. See my comments above about fear and greed.

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 few opportunities now, and we haven't made any purchases in many months. We are looking for the exits here as well. Convertible bonds are likewise pricier and we are having trouble finding great ideas.

We remain disciplined sellers as prices reach full value, and when evaluating new undervalued buying opportunities. The environment, like the seasons, is changing, and we want to make sure we don't get caught out in the cold with inadequate protection.

I'd like to welcome David M. Hutchison, CFA to the Triad family. David and I have known each other for the past five years, and after many discussions it was apparent that our common philosophies and experiences could create a successful business relationship. Initially, Dave will be leading our marketing and business development efforts. I'm glad to have him aboard and look forward to introducing Dave as the opportunity arises. Welcome Dave!

Let us know if you'd like a copy of our SEC Form ADV Part II. Also let us know of any changes to your financial situation that might suggest altering your 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
January 29, 2013

"Many shall be restored that are now fallen and many shall fall that are now in honor." Horace

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