TRIAD INVESTMENT MANAGEMENT

1301 Dove Street, Suite 1080
Newport Beach, CA 92660
Tel: (949) 851-7902
www.triadim.com

2nd Quarter 2013 Investment Review

Investment Thoughts

Benjamin Graham wrote ***"The Intelligent Investor"*** in 1949. Berkshire Hathaway CEO and Super-Investor Warren Buffett studied under Graham at Columbia University and worked at Graham-Newman for a few years before striking out on his own. Buffett has commented that he found Chapters 8 and 20 to be most important for investment success. Not wanting to recreate the wheel, I've spent a fair amount of time reading, rereading and thinking about these chapters. Guess what? It's had an impact on our philosophy. If it's good enough for the world's richest person (give or take a billionaire) it should be good enough for Triad.

What follows are the most important excerpts from these two chapters. Since Triad's investment philosophy is based in large measure upon these ideas, having a better understanding might make the next nerve-rattling market decline more palatable. I've bolded areas I feel are especially important. Indulge me and read the entire letter.

Chapter 8-The Investor and Market Fluctuations

"Imagine that in some private business you own a small share that cost you $1,000. One of your partners, named Mr. Market, is very obliging indeed. Every day he tells you what he thinks your interest is worth and furthermore offers either to buy you out or to sell you an additional interest on that basis. ***Sometimes*** his idea of value appears plausible and justified by business developments and prospects as you know them. ***Often, on the other hand, Mr. Market lets his enthusiasms or his fears run away with him, and the value he proposes seems to you a little short of silly.***

"If you are a prudent investor or a sensible businessman, will you let Mr. Market's daily communication determine your view of the value of a $1,000 interest in the enterprise?…You may be happy to sell out to him when he quotes you a ridiculously high price, and equally happy to buy from him when his price is low…but the rest of the time you will be wiser to ***form your own ideas of the value of your holdings***, based on full reports from the company about its operations and financial position…Basically, ***price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal.*** At other times he will do better if he forgets about the stock market and pays attention to his dividend returns and to the operating results of his companies."

Chapter 20-Margin of Safety as the Central Concept of Investment

"Investment is most intelligent when it is most ***businesslike.*** It is amazing to see how many capable businessmen try to operate in Wall Street with complete disregard of all the sound principles through which they have gained success in their own undertakings. ***Yet every corporate security may best be viewed…as an ownership interest in, or a claim against, a specific business enterprise.*** And if a person sets out to make profits from security purchases and sales, he is embarking on a business venture of his own, which must be run in accordance with accepted business principles if it is to have a chance of success…The first and most obvious of these principles is, ***Know what you are doing***—know your business…A second business principle: ***Do not let anyone else run your business***…A third business principle: Do not enter upon an operation—that is, manufacturing or trading in an item—unless a ***reliable calculation shows that it has a fair chance to yield a reasonable profit***. In particular, keep away from ventures in which you have little to gain and much to lose…***For the enterprising investor this means that his operations for profit should be based not on optimism but arithmetic***…A fourth business rule is more positive…***Have the courage of your knowledge and experience.*** If you have formed a conclusion from the facts and if you know your judgment is sound, act on it—even though others may hesitate or differ…***You are neither right nor wrong because the crowd disagrees with you…You are right because your data and reasoning are right***…Similarly, in the world of securities, ***courage becomes the supreme virtue after adequate knowledge and a tested judgment are at hand***…To achieve ***satisfactory*** investment results is easier than most people realize; to achieve ***superior*** results is harder than it looks."

So there you have it. What Graham wrote and Buffett discovered is this: spend your time analyzing and understanding how to value investments. Ignore the stock market except when it presents remarkable opportunities due to periodic investor foolishness. Said Buffett in the 1987 Berkshire Hathaway annual report:

> "*An investor will succeed by* ***coupling good business judgment with an ability to insulate his thoughts and behavior from the super-contagious emotions that swirl about the marketplace.*** *In my own efforts to stay insulated, I have found it highly useful to keep Ben's Mr. Market concept firmly in mind.*"

Over six decades later, Graham's concepts remain as valid as ever. Analyze businesses until you can adequately understand and value them, and insulate your behavior from the occasional irrationality of securities markets. I've said it before and it's worth saying again: ***investing is simple but it's not easy.*** The relatively simple part is assessing business value and deciding when a sufficient "Margin of Safety" is present. The more difficult part is keeping your emotions under control. Even Buffett has to remind himself of the Mr. Market parable when markets become irrational.

Why force you to read this? First, in addition to managing investments, it's our job to periodically communicate our investment philosophy and process. This is partly self-serving, as a well-informed client is more likely to stick around in tough times. At least that's the hope. Second, you may have noticed that Mr. Market has been at it again lately, gyrating daily based on his ever-changing emotional condition. What's important is ***we spend our time analyzing companies and their results, not the stock market.*** We focus on the playing field—business results—not the scoreboard of daily stock market prices. If we do our job and select investments with an adequate Margin of Safety (which means buying well below our assessment of investment value) and remain emotionless in deciding when to buy or sell, our chances of long-term success should be greatly enhanced. And it's only in the long-term that significant results happen.

Our firm philosophy is primarily based on the two principles laid out by Ben Graham and highlighted by Warren Buffett: ***Good Research*** and ***Good Behavior***. We've added a third principle: ***Ethics***. We operate ethically and expect the companies we invest in to do the same. So there you have it: ***Behavior, Research, Ethics***. That forms our Triad.

Economic Conditions

Last quarter I wrote the following:

> "Internationally, Europe is still in recession and things don't appear to be getting better. It's going to be a long slog for Europe. China remains a wild card, with the government's ability to manage sufficient economic growth in question given a past spending boom that could turn into a real bust. Chinese officials have a difficult rebalancing act ahead away from export-driven growth and toward domestic consumption. Let's hope they get it right."

Three months later, it's not looking great. Europe is still a mess, and China is facing difficult times, as a government-controlled economy meets global realities. I've assumed that centrally-planned economies will create centrally-planned problems, as markets are usually best at allocating resources. But Beijing has defied the skeptics for years. It appears the next decade will be tougher than the last. This matters as China has a huge population and will influence the world economy and investment markets for many years.

The good news is here in the U.S. of A. economic conditions are better. Housing markets continue to heal, auto sales are strong, domestic energy production is growing, and U.S. competitiveness gets better by the year. Now if we can just get the folks in Washington D.C. to provide some leadership on spending and budget deficits. Quit laughing.

Investment Conditions

Market volatility has increased over the past month or so. Why? The Bank of Bernanke has recently discussed reining in the extreme actions taken over the past four years to prevent The Great Depression, Version Two. As the Federal Reserve pulls back on the monetary levers, short and long-term interest rates will rise to more normal levels. When and how high, you might ask? My best guess is rates will rise gradually over the next 2 to 3 years and we'll see short-term rates around 2.5% to 3.5% and long-term rates around 4.0% to 5.0%. Just a guess. Still very low compared to double-digit rates in the 1980's and 1990's. But the important point is it's a change from near-zero interest rates of the past few years. Markets don't like change, especially change of uncertain length and magnitude.

The predictable result? Mr. Market has been in a bit of a tizzy of late. Investors see the inevitable rise in interest rates, and in like-minded fashion, everyone heads for the exits at the same time, resulting in declining prices. Aren't markets smart? In the short-run, often not. In the long-run, yes they are. We aim to take advantage of short-run foolishness, and be rewarded by Mr. Market in the long-run. So fasten your seat belt.

We continued to pare our housing-related positions during the second quarter, while maintaining our large exposure in the still-not-very-much-loved financial sector. We go where the opportunities are, and survivors of the financial crisis still seem a good bet. When the world embraces these outcasts, we'll bid farewell and look for the next major opportunity.

We increased our holdings in the energy area, as global growth fears and booming U.S. production have investors concerned about lower demand and increased supply. Just look around the world at all of the people who still lack adequate transportation, heating, electricity and other forms of energy. The long-term outlook still looks pretty good to us.

Rising stock prices over the past few years mean it's no longer like shooting fish in a barrel. We must search a little harder and dig a little deeper to find the values that meet our absolute criteria. It's not impossible, but the flipside to higher portfolio values is fewer opportunities.

Bonds are still a mediocre choice for the most part. Interest rates have popped up a bit, but we're still a long way from declaring bonds attractive. We continue to emphasize shorter maturities and remain choosy among corporate, convertible and municipal bonds.

Our investment performance was mediocre in the second quarter. Year to date we're still positive but by less than we were. I bring this up for two reasons. First, we don't ignore poor results. Rather, we expect this occasionally. Second and more importantly, we don't manage for three month results. We don't even manage for one year results. We have a three to five year timeframe to allow sufficient time for our analytical reasoning to unfold. Hopefully. So far, based on our five year results, it's been the case. And we are working to make the next five years a success. As the saying goes, it's a journey, not a destination.

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

I remain confident in our philosophy and investment process, and still believe respectable investment returns can be achieved over the next 3 to 5 years. I encourage comments, questions and suggestions. As always, your loyalty and patience remains our secret weapon.

Sincerely,

John Heldman, CFA
July 19, 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