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**2nd Quarter 2014 Investment Review**

## Investment Thoughts

While investors love to discuss their successes, it's also important to analyze the ones that didn't work out. Rational, objective analysis is an essential ingredient for investment success. Reviewing mistakes should encourage humility and reduce future blunders.

So let's discuss Failure. The dictionary defines failure as the "omission of expected or required action". For investors failure in its simplest form is selling an investment for a loss. That's an ***act of commission***. But that's only half of it. The failure could also be an ***act of omission***, such as failure to purchase an attractive investment. This act of omission is unseen, because it's not staring at you on the statement. But it could be a mistake nonetheless.

As you might guess, we have some real-life examples of both types of failure, ***commission*** and ***omission***. They were committed by us. Well, actually, by me. It's good to periodically rub our noses in instances of poor decision-making.

Exhibit Number One is Walter Energy. Walter was recently relieved of its duty in all of our portfolios. Sold. Gone. Bye-bye. It was a mistake. One of our bigger losers in percentage terms. We made numerous mistakes here. Let us humbly recount them.

Walter operates in the commodity-based business of metallurgical coal, the stuff used to make steel. The price goes up and down along with the demand for steel. ***Mistake number one, investing in commodity-oriented businesses that have no control over prices***. "*But wait*" as the late-night TV commercial says, "*there's more*". Walter benefited from booming steel production due to enormous demand from China. As China's economy has slowed, demand has receded appreciably. ***Mistake number two, investing in highly cyclical commodity businesses***. Walter bought another coal company at the top of the demand cycle. ***Mistake number three, overpaying for a cyclical business***. Walter not only paid up but borrowed to fund the purchase. ***Mistake number four, investing in a leveraged business***. As demand dropped, sales and earnings evaporated. The debt taken on however, stuck around. It usually does. We thought we were protected from these risks as we started buying the stock only after it had declined 75% from its highest price. ***Mistake number five***. Just because a stock has dropped a lot, doesn't mean it can't drop some more. One last thing. Walter management doesn't own much stock. We like to invest with managers who own lots of stock compared to their salaries. ***Mistake number six***. That's probably enough to declare defeat.

We finally came to grips with the situation and sold. Walter might stage a miraculous recovery. It doesn't matter, as we won't be revisiting this business. Ever. Walter has been kicked out of our universe, and won't ever be invited back in. Our stock in trade is buying good quality businesses run by capable owner-managers when available at bargain prices.

We share the pain, as we personally owned Walter Energy along with clients. ***We truly eat our own cooking.*** In this case, all we got was a case of food poisoning. Fortunately it's not life-threatening. But we aim to avoid these salmonella-laced investments in the future.

Now onto ***errors of omission***, or not acting when you should have. Sitting on your hands when action is warranted can be just as much a mistake as buying a lousy investment. Let's take a look at a recent example.

We purchased International Game Technology—the dominant manufacturer of gaming slot machines in the U.S.—for most clients in early May. The stock declined over the previous nine months from roughly $20 per share to around $12.50 when we bought most of our position. We had been analyzing the company for years, and felt the price finally approached bargain territory. Granted it's not the same near-monopoly business that it had been in previous years. Increased competition, U.S. gambling industry market saturation, questions about IGT management capability and future online gaming competition required a very cheap price to get us interested. But when we started buying we believed the price was right. We bought about half as much as normal, but in hindsight ***we didn't buy enough.***

Reasons? Mostly not enough cash reserves and tax considerations. But the bottom line is we should have bought more. Why? IGT just announced that it's being acquired by GTech, an Italian gaming/lottery equipment maker. IGT currently sells for around $17 per share, or 35% above our average purchase price. I'm not complaining about a 35% return in two months, but we should have owned a larger position. Yours truly didn't benefit as I was one of the non-holders of IGT. While we eat our own cooking, I missed out on this dessert.

Now before you get the wrong idea, we're happy to announce that these occasional blunders are few and far between. Most of the time, we get it right. We've gone back and looked at our investments over the past six years or so, and by a very significant majority our selections have been profitably sold. This in and of itself, doesn't tell you everything, but ***we think our "batting average" has been pretty good.*** And we tend to act when action is called for. Take a look at our investment results on the next page. We think you might agree.

## Economic Conditions

The Federal Reserve continues to provide the sugar high to keep the economy moving along. While the amount of stimulus provided is unprecedented, so too were conditions in the aftermath of the financial crisis. The likely impacts from low interest rates remains to be seen, but opinions have divided into two camps. Camp Savior believes we'd be in a depression without Fed intervention, while Camp Unintended Consequences believes another bubble and eventual rampant inflation lies just around the corner. We're in Camp Agnostic with our cloudy crystal ball. We'll just keep our eyes open and prepare for trouble.

Interest rates have only one direction to go and that's up over the next several years. While the economic impact is likely to be modest, the psychological impact could be stronger. Investors will likely panic that rates will increase dramatically as the Fed begins its levitation tango. With our companies there will be some positives to go along with the negatives of rising rates. Bottom-line, while the Psychology Department influences the short-term, the Economics Department prevails in the end.

## Investment Conditions

Our second quarter results were much better than the first quarter, but we always focus on longer-term results. Our Concentrated All-Cap Composite returns are shown below:

| | 1 Year | 3 Year | 5 Year | Since Inception* |
|---|---|---|---|---|
| Triad | 26.6% | 17.9% | 23.0% | 13.0% |
| S&P 500 Index | 24.6 | 16.6 | 18.8 | 8.2 |
| Russell 3000 Index | 25.2 | 16.5 | 19.3 | 8.6 |

Net of fees; periods one year or greater are annualized. *April 30, 2008

We're not in the business of blowing our own horn. We believe our results should speak for us. But we're proud of the fact that despite enduring one of the worst market declines in decades during late 2008 and early 2009, our clients had the courage to stay the course and allowed us to focus on protecting and growing their capital over the past six years.

We ***still view stocks as fairly valued at best.*** Should the economy weaken or profits come under pressure, valuations will likely appear even higher. Since we take things one company at a time, we have the luxury of investing only when the business and the price seem right.

On that score, we still like what we own. We invest when we believe a company's shares have a reasonable chance of doubling over a three to five year period. We still think that's the case with our portfolio. but we don't think the major stock market averages are going to come anywhere close to doubling over the next five years. So we like our absolute and relative prospects.

We encourage comments, questions and suggestions. As always, your loyalty and patience remains our secret weapon.

Sincerely,

John Heldman, CFA
July 21, 2014

***"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**

The securities discussed herein do not represent all of the securities purchased, sold or recommended for each strategy during the quarter. The reader should not assume that an investment in these securities was or will be profitable. Inherent in any investment is the possibility of loss. Past performance is no guarantee of future results.

Triad claims compliance with the Global Investment Performance Standards (GIPS®). Triad has been independently verified by Ashland Partners & Company, LLP for the period from the strategy's inception, April 30, 2008, through March 31, 2014. Triad is an SEC-registered investment advisor. The composite includes all fully discretionary separately managed accounts that follow the firm's Concentrated All-Cap Equity investment strategy, including those accounts no longer with the firm. Triad's strategy is to invest in a concentrated portfolio (usually holding between 20 to 30 securities) of common stocks, unrestricted as to market capitalization, of both domestic and international companies. The U.S. Dollar is the currency used to express performance. Past performance is not a guarantee of future results. Results are presented net of fees and include the reinvestment of all income. Investments made by Triad for its clients differ significantly in comparison to the referenced indexes in terms of security holdings, industry weightings, and asset allocations. Accordingly, investment results and volatility will differ from those of the benchmarks. As of June 30, 2013, the Triad Equity Composite has been renamed the Concentrated All-Cap Equity Composite. For more information or for a copy of the firm's fully compliant presentation and the firm's list of composite descriptions, please contact us at (949) 679-3991.