TRIAD
INVESTMENT MANAGEMENT

1st Quarter 2010 Client Letter

"At the time it looked like a sound investment. When the market tanked, we got caught"
- Clark McKinley (spokesman, California Public Employees Retirement System)
Quoted in the New York Times, January 26, 2010

This lesson in human behavior begins in Manhattan, New York, home to Wall Street and "high finance". Stuyvesant Town and Peter Cooper Village, an 80 acre 11,000+ units apartment complex was sold in October 2006 for $5.4 billion to a partnership including BlackRock, Tishman Speyer, CalPERS, CalSTRS (California State Teachers Retirement System), the government of Singapore, Church of England, Fortress Investments and others. These are some of the largest investors on the planet, with extensive resources and able to analyze all types of investment opportunities.

Three years later, these owners have defaulted on the debt and handed the keys to the lenders, as the cash flow isn't sufficient to service the property debt. The partnership's $1.9 billion investment is worthless. The complex was recently appraised at $1.9 billion, or 35% of the 2006 purchase price. Not only is the owner's investment gone, but the lenders will take a big loss on the eventual debt resolution. The Wall Street "helpers"? Wachovia and Merrill Lynch, both of whom got into further trouble and have been taken over by Wells Fargo and Bank of America, respectively.

What's so notable about this deal? After all, real estate values nationwide have declined over the past three years. However, this one stands out because when the deal closed the property was generating only 60% of the cash flow needed to service the purchase debt. But the new owners assumed they could raise the rents significantly over the next 5 years on many of the rent-controlled units from roughly $1,300 to $3,200 per month. No surprise, with the help of local politicians, community activists and ultimately the New York State court many of the rent increases were rolled back or prevented and the hoped-for cash flow increases never materialized.

The lesson in this financial mess? To quote Warren Buffett "you pay a very high price for a cheery consensus". Or as Benjamin Graham (Buffett's mentor) would say, these investors had no "***margin of safety***". I've spoken about this before; it's a simple concept, but investors tend to ignore it at precisely the wrong time. Some call it wearing a belt and suspenders. Engineers refer to it as redundancy, building into a system duplicate and sometimes triplicate critical components to guard against catastrophic failure. In the case of "Stuy Town", paying a price that **required** rent increases, which are not guaranteed, results in no margin of safety. In the end it was, to quote the English author Samuel Johnson, "***a triumph of hope over experience***".

Triad was founded with three primary common stock investment principles in mind: **Moats**, **Management**, and **Mr. Market**, whose manic-depressive behavior can provide a ***margin of safety***. Actually, all three principles provide a margin of safety. I look for durable businesses which have some "moat" characteristic, meaning a business that has some protection against aggressive competitors. Next, I look for management with a history of operating in our interests as shareholders and with "skin in the game" (stock ownership). Once I identify a good business with good management, I wait until we can invest at a suitable discount to long-term intrinsic value. This can require at times a great deal of patience. Mr. Market, the same fellow who was selling stocks in early 2009 at giveaway values, provides occasional opportunities to buy well below intrinsic value. If we identify durable businesses with managers who know what they're doing and are invested alongside us, and the purchase is at a discount to business value, we should have a reasonably good **margin of safety** in the event the world doesn't unfold the way we expect. Just ask the folks who invested in "Stuy" Town.

But enough of the past, how do things look today? The economy is demonstrating many signs of recovery. Consumers have resumed spending, but are still paying down debts ($500 Coach purses and $70,000 cars seem to be less popular). Even housing is starting to exhibit signs of life. Overseas, Asia is growing nicely while Europe continues to limp along. The financial crisis is receding and capital is flowing again. The world economy will grow this year and probably next year. But the healing process will continue for several more years. The big unknowns are the effects of eventual interest rates increases and reduced government support. I'll continue to monitor and attempt to be prepared for both.

Meanwhile, asset allocation still favors equities. Although common stocks have rebounded significantly over the past year, valuations are still reasonable, and selected stocks still seem more attractive than most bonds. That will change at some point, but we're not there yet.

I have reduced or eliminated a few positions this year, where stock prices increased significantly and reached a near-term target. Cash levels have risen a bit, and may increase further if stock prices continue to move up. And yes, capital gains have been generated as a result. I always consider taxes before making a sale decision, but many years of experience has taught me to pay attention to capital gains, but don't let the tax consequences dominate the decision. Sometimes it's better to pay the taxes and move on.

The stock portfolios continue to tilt toward companies that benefit from a stronger economy. This means industrial, manufacturing, energy and real-estate related companies. At some point investors may get too optimistic about the outlook for these companies, and we'll probably be moving on to other areas. Good values tend to occur in areas that others ignore, so that's where I look for new ideas. Investors today are largely ignoring areas like healthcare and stable consumer companies since they don't get a big lift in an economic recovery. We currently have very little in these areas but may find attractive investments as the year wears on.

Lastly, sincere thanks to those clients who have made referrals to friends, relatives and business associates. Your referrals allow me to stay focused on managing your assets and not on the golf course looking for clients. Also, I'm always looking for suggestions to improve my quarterly letter. Don't worry, I have a relatively thick skin. Feel free to pass them along.

As always, I very much appreciate your patience and loyalty.

Sincerely,

John Heldman, CFA