TRIAD INVESTMENT MANAGEMENT

3rd Quarter 2010 Investment Review

"You better cut the pizza in four pieces because I'm not hungry enough to eat six."
-Yogi Berra, New York Yankees retired player/manager

Would you rather have 1,000 shares of a $100 stock, or 10,000 shares of a $10 stock? Yogi might take the 10,000 shares and I'd guess most people would choose 10,000 shares; it's a big number, and intuitively seems like more. But the values are an identical $100,000. According to a recent Financial Times article new employees at Facebook, the social networking website, would rather have more shares. Although privately-held, Facebook shares trade on a secondary market and have recently been soaring in value as the number of users grows. So, Facebook recently split its shares 5 for 1. The article quotes a lawyer close to the company: "People would rather have 1,000 shares worth $10 than 100 shares worth $100. Says a Facebook employee: the split "gives larger grants to employees without dilution to existing shareholders". Sorry, but I don't think so.

Whether you split a stock 2 for 1, 10 for 1, or 20 for 1 the business value doesn't change, just as a pizza doesn't magically grow in size if cut into more slices. If splits increased business value, they would occur frequently. I found myself chuckling that even the astute folks at Facebook are susceptible to a little mental self-deception. I mention this because the ability to recognize mental stumbling blocks and act rationally is an important part of long-term investment success.

The economic outlook appears to be improving, but I'm not ready to declare victory. While the dreaded "double dip" recession seems less likely with each passing day, there is still a fair amount of distress in the world. Consumers show no appetite for a return to the days of spending like a drunken sailor. Housing remains depressed, with new single-family home construction averaging roughly 500,000 per year for the past two years, against a need for around 1 to 1.5 million new homes each year just to keep up with population growth and the aging stock of housing. Single family housing starts were never less than 1 million per year during the entire 1992-2007 period. So we are under-building by roughly 1 million new homes each year, which will slowly work off the existing home glut. Automobiles continue to age and will need eventual replacement. However, weak job growth and high unemployment is holding back consumption. This results from a combination of corporate nervousness and businesses finding new ways to do the same amount of work with fewer employees.

I suspect that a good part of the sluggish job growth may be due to structural changes in the economy. We continue to lose jobs to foreign competition, and new technologies further automate processes and eliminate jobs. If you find yourself "outsourced" to China, India or a machine, it can take a very long time to find an equivalent paying job; many workers are forced to go back to school to learn new skills for a changing economy. The current recession ended in June 2009 (at least according to the experts) but since then the economy has produced no net job growth. Similarly, the previous 2 recessions in 2001 and 1991 also produced very little job growth 15 months after the recession officially ended. In contrast, during the 1970's and 1980's, at this point in the recovery the economy had produced net job growth of 2% to 4%, which translates into millions of new jobs. To me the evidence is clear: the U.S. economy continues to transition, shedding jobs in areas where global competition and technology force change (look no further than the auto industry). Unfortunately, it's going to take some time for this trend to abate.

I came across a sobering example of this in a recent Financial Times article about economic conditions in the town of Rockford, Illinois. Current unemployment rate: 16%, the highest in Illinois. A working-class town of about 150,000 people 90 miles northwest of Chicago, the town began to lose jobs in the 1970's and 1980's as manufacturers moved production overseas or went out of business due to foreign competition. Unemployment in Rockford hit 25% by the early 1980's. The mayor, Lawrence Morrissey said: *"we're still going through the transition. Many of the problems we're dealing with are the same we've always had".* Imagine, 25 years later this town is still adjusting to a global shift that eliminated many manufacturing-based, high-wage jobs. Rockford might be an extreme example but I believe the U.S. economy has been dealing with structural changes for the past 20+ years, and we have a bit further to go. The good news is ultimately all of this "creative destruction" improves long-run business productivity, profits, and ultimately our living standards. However, it doesn't make it any easier on workers in Rockford and other areas of the country.

Our investment results for the year to date have been quite satisfactory, with common stock portfolios comfortably ahead of most major indices. Longer-term results as well have been above the benchmarks. I bring this up two reasons: First, it's nice to be ahead of the game, but it's a relatively short period of time, whether we're talking about nine months of 2010, or results since I founded Triad in early 2008. I'm focused on long-term results. Second: in the future, our results might trail the "market" for a period of time, whether measured by the Dow Jones Industrial, S&P 500 or some other index. I want clients to understand that at times I might be out of step with the broader market. It's a natural outcome of avoiding "herd" behavior, being disciplined and maintaining a long-term focus. If you want an abnormal rate of return, you need to invest in a manner that's different from the rest of the crowd.

While I don't attempt to forecast stock market returns, the prospects for common stocks seem reasonably attractive over the next 3 to 5 years, especially compared to the ridiculously low yields available on U.S. Treasury bonds, high-quality corporate bonds, and municipal bonds. So where is the average investor putting his or her money? That's right, bonds. Bond funds have been very popular over the past 2 years, while investors pull billions out of stock funds. Wall Street and major corporations are only too happy to satisfy the bond feeding frenzy by issuing enormous quantities of new debt at unheard of low interest rates. An example: IBM recently sold $1.5 billion of 3 year bonds with a 1% interest rate. IBM common stock currently yields 1.8%. Another example: Microsoft sold $1.75 billion in 5 year bonds paying 1.625% interest. After taxes and inflation, it's a negative return. Meanwhile, Microsoft common stock yields roughly 2.6%, more than the 5 year bonds. If Microsoft raises its dividend 10% per year, which it clearly has the ability to do, the yield in year 5 would approximate 4.3% based on today's purchase price of $24 per share. The Microsoft bond investor would be getting the last of his 1.625% interest payment. Bonds today resemble the new "dot-com" investment era of the late 1990's. Or real estate in 2006. Not a lot of intrinsic value, but a lot of believers. The Jimmy Buffett song sums up my current feelings about most bonds: *"If the phone don't ring, you'll know it's me".*

However, a few areas of the bond market look reasonable to me: higher-quality high-yield bonds (ok, "junk bonds") and selected convertible bonds. These bonds were a plain giveaway back in late 2008 and early 2009 when financial Armageddon appeared to be close at hand. Since then, junk bond prices have increased significantly, and the enormous bargains are gone. But certain 'junk" issues seem reasonably priced and can provide yields of roughly 6% to 8% with relatively short maturities of 2 to 7 years. Convertibles, as the name implies, can be converted into common stock of the company that issues the convertible bond. In exchange for a lower interest rate on the convertible, the investor has upside should the common stock perform well. If the common stock does not perform well, the convertible bond investor gets his capital back when the bond matures. So, it's "heads I win, tails I don't lose much". There are a handful of convertibles that look more attractive than handing Microsoft your money for 5 years and getting paid 1.625% per year in return. In short, patience and flexibility are necessary in bonds today and I continue to search for overlooked opportunities; they're just not readily available.

The major point of all this is this: as I repeat frequently, investors seem to make a habit of hopping on the bandwagon of recent winners. Bonds have provided relatively steady, positive returns over the past 10 years, while common stocks have provided pretty much no return. So, using the rear-view mirror, investors pile into that which has done well recently, while avoiding like the plague the recent losers; that is, the disappointing stock market. I'd be very surprised if the next 10 years plays out like the past 10 years as regards stock and bond returns. I will repeat one of my favorite quotes from the comic strip character Pogo (if you're under 40, you might not remember): ***"we have met the enemy, and he is us".*** When investing, we are often our own worst enemy.

To guard against becoming our own worst enemy, the investment process I use endeavors to be disciplined to avoid mental biases and minimize mistakes. Conceptually it's pretty simple. First determine the intrinsic value of an investment. Next, the value is compared to the market price. If a significant discount to intrinsic value is available, I will invest. For common stocks, I look at three primary elements: Business quality (how deep and wide is the moat around the castle), Management, and Valuation. That's it. When all three are lined up in our favor, and the odds suggest limited risk of permanent capital loss (not to be confused with short-term market fluctuations) I will invest. When the odds do not seem favorable, I'll keep the wallet shut until bargains appear.

I have enclosed a copy of Triad's Privacy Policy regarding collecting and keeping private your nonpublic personal information. In addition, let me know if you'd like a copy of our SEC Form ADV Part II. Also, please let me know of any changes to your personal financial situation that might suggest altering your current investment portfolio.

As always, I thank you for your patience, confidence and trust. I don't take trust for granted and realize it must be earned over time.

Sincerely,

John Heldman, CFA