TRIAD INVESTMENT MANAGEMENT

4th Quarter 2010 Investment Review

"The chains of habit are too weak to be felt until they are too strong to be broken"
-Samuel Johnson, English Author

For the past several years, many investors have gotten into the habit of selling U.S. common stocks, and putting the proceeds mostly into bonds. On the surface that seems reasonable; investing in stocks over the past decade has been a painful experience for most investors. Two significant market drops in 2001-2002 and 2008-2009 have resulted in losses over 10 years and scarred investors' psyches. As a child who gets burned on a hot stove learns, you stay away from things that cause pain. And so, fed up with the pathetic stock market, and enticed by the much steadier returns from bonds, investors have allowed the chains of habit to form. These chains of habit exert a powerful influence and lull investors to stay with what's popular and comfortable while avoiding neglected or uncomfortable investments. Unfortunately, that's not a winning long-term strategy. As Warren Buffett has remarked "***you pay a very high price for a cheery consensus***". For the past few years, the consensus has been: 'sell stocks, buy bonds". We must remember that markets oscillate between Greed and Fear. Over the past couple of years, Fear has been in the driver's seat, hauling a big load of U.S. Treasury and corporate bonds.

The November 2010 Investment Company Institute figures show U.S. investors have pulled roughly $48 billion from equity mutual funds since the stock market bottomed in February 2009. Meanwhile during the same period over $625 billion has gone into bond mutual funds. Remarkably, and regrettably for many, over the past two years the stock market has almost doubled from its low point, and individual investors collectively didn't add a dime to their holdings, but rather redeemed $48 billion.

This "rear view mirror" investing approach is not just confined to the average "retail" investor. The big boys, the pension plans of large corporations, the sophisticated seers with their expert advice, have been doing essentially the same thing. A recent Wall Street Journal article pointed out that pension assets in stocks peaked at roughly 70% in the mid-2000s coinciding with stock market highs. As the market has since trended lower the percentage has come down, due partly to market declines but also reallocation away from stocks; as of July 2010 pension plan stock exposure had been reduced to around 45% of assets. A cynic might point out that these pension managers are thinking primarily about job preservation and reducing future pension funding costs while being less concerned about the long-term financial health of their retirees. After all, it's not their money.

Now that the stock market has demonstrated renewed vigor of late, investors are beginning to show interest. Commitments are being made to stocks once again, and recent investor sentiment polls reveal almost 60% are optimistic today compared to only 30% last Summer. Unfortunately for these later arrivals this is typical behavior and a contrary signal for us to be more cautious in the short-term. Buy low, Sell high. It's a simple idea, but powerfully difficult to do. For many investors, it's "*buy high, hope to sell higher*". Which of course is a variation of the greater fool theory. This is why I frequently mention my favorite quote from Pogo, the comic strip character: ***"we have met the enemy, and he is us"***. Truer investment words were never spoken. Most investors are their own worst enemy. And as long as individuals participate in the stock market, it will remain this way. In other words, for a very long time.

When it comes to investing, as in other areas of life, the road less traveled can be more rewarding. Evidence abounds in the investing world that thinking independently and ignoring the herd can pave the road to success. For example, according to Bloomberg Financial companies in the Standard and Poor's 500 Index that analysts loved the ***most*** rose 73% since the stock market began to recover in March 2009. Seems like a good result. However, companies that the analysts liked the ***least*** rose 165% over the same period. How can that be? Simple. When everyone loves something, the price reflects the love. Conversely, where neglect or revulsion is evident, the investing crowd often places too much importance on short-term problems, depressing prices and creating an opportunity. Yet another reason why I avoid Wall Street and its "helpers". It's much more profitable in the shadows than the light.

Investing entails myriad variables but essentially can be reduced to a few simple concepts. Albert Einstein said ***"Make everything as simple as possible but not simpler"***. Triad employs 3 (hence the name Triad) simple concepts: 1) Buy durable businesses (Moats) that can survive a range of possible outcomes. 2) Invest with capable owner-managers (Jockeys) whose interests are closely aligned with your own. 3) Pay less than intrinsic value by taking advantage of our imaginary friend "Mr. Market", whose occasional bouts of irrationality provides opportunities. That's the essence of Triad's approach. Moats, Jockeys and "Mr. Market" are the keys to our investment process and, hopefully, success. Every Triad investment is analyzed through the prism of these three concepts. Simple, yet it entails analyzing thousands of individual facts and making judgments about businesses, people and what price to pay. It's relatively easier to identify good businesses with good owner-managers. What's harder is determining the price to pay, and still harder is being patient and waiting for a bargain price to arrive. It can take a long time. But, when that time arrives and the odds appear to be in our favor, we will place our bets. Otherwise we will read, learn, analyze. And wait as long as it takes.

While I do spend time analyzing individual businesses, I don't spend a lot of time trying to figure out what the economy is going to do in the immediate future, other than reading newspapers and magazines and listening to comments from business owner-managers . There are already plenty of economists and analysts who can do a far better job of *incorrectly* predicting interest rates, inflation, GDP growth, unemployment, etc. I subscribe to the philosophy of retired investment manager Peter Lynch: "***If you spend 14 minutes a year on economic forecasting, you've wasted 12 minutes***". With that warning let me spend my self-allotted 2 minutes discussing the Big Picture.

The U.S. economy is still in recovery mode, with employment finally starting to grow slowly, consumer spending picking up and business leaders more optimistic than any time since early 2006. Since businesses have been squeezing more out of existing workers, any improvement in outlook should translate into somewhat better employment growth. Corporate profitability is strong, interest rates are low (although due for a rise) and inflation remains in check. Housing continues to struggle, and it appears we won't see real progress until 2012. Meanwhile, individuals continue to make progress in reducing debt (Mercedes and McMansions are out, Chevrolets and Cottages are in). Overall, the U.S. economy remains in repair mode, and 2011 will be another repair year. Next year seems likely to be better.

I'm relatively optimistic about longer-term prospects over the next 3 to 5 years. Stocks still make more sense than bonds, despite recent stock market gains. Many stock dividend yields remain higher than yields on high-quality bonds, with the potential for dividend growth. Larry Fink, CEO of BlackRock, the world's largest money manager (and one of the largest bond managers on the planet), stated the case succinctly in the Financial Times recently: "I tell people the best investment today would be investing in a large portfolio of dividend equities and then go on vacation for five years".

Triad's three year anniversary is approaching in April, and so far the investment results have been quite satisfactory. It's a short time period and I'm not declaring victory, but the view is much better up toward the front of the pack, not the rear. Also, as I've said before we will likely encounter a period of time when the results trail "the market". Avoiding the investing herd increases the potential of looking foolish and out of sync for a period of time. It goes with the territory of doing things differently from other investors. If you want an abnormal rate of return, you need to invest in an "abnormal" manner.

I have immensely enjoyed the almost 3 years since Triad was founded, and look forward to the next 10 years and beyond. It's because of great client relationships that the entire process has been relatively smooth. Thank you for your patience, confidence and trust.

Also, I appreciate your referrals and the additional opportunities to assist clients that have come along in the past few years. I recognize that integrity and ethical behavior are the foundations of a lasting long-term relationship, and make every decision with these ideals in mind.

Sincerely,

John Heldman, CFA