TRIAD
INVESTMENT MANAGEMENT

Client Commentary
September 2, 2011

I apologize upfront for the long-winded nature of this email, but it's important to discuss the current situation in some detail, and I thank you in advance for reading the entire email.

Let me state this upfront: NOTHING has changed in my view of long-term expectations. While the stock market is down roughly 15-20% or so in the past 6 weeks, the long-term value of the companies we own hasn't declined by a corresponding amount, so we must ride out this period of FUD (fear uncertainty and doubt). This is when most investors make the mistake of jumping ship and selling, which is what investors in aggregate have been doing all year.

What has changed is the volatility of markets. When uncertainty increases, volatility increases. Investors are operating as if in a fog, with no clear vision in the SHORT TERM (and I emphasize the short-term), but, I repeat, just because stocks have dropped 20% or so, doesn't mean the VALUE of the companies has declined by that amount. Business values just don't change that dramatically. The stock market provides an opportunity for irrational investors to engage in foolish short-term behavior, but we won't participate in the foolishness. It's in the nature of the beast for investors to put an inordinate amount of emphasis on current conditions, when the reality is investing happens over decades.

We have 2 options at this point: sell stocks and join the rest of the crowd, or, hold on and wait out this period of decline and discomfort. If we sell, the challenge would be determining the appropriate time to reinvest in the stock market. I've been at this for 25 years, and it still remains a very difficult challenge to time the re-entry back into the market. Couple the re-entry timing challenge with a couple of other facts—we are holding well-run companies selling at ABSURD valuations, at least in my view, so while short-term declines feel painful, ultimately it's the long-term business performance that determines our investment results. As long as our companies are making BUSINESS progress, we will get STOCK MARKET results, and if business progress continues, the ultimate stock market results should be that much more powerful when the economy resumes a normal trajectory and investors overcome FUD.

Some clients may be wondering, "Why didn't you see this coming and why didn't you sell more stocks?" Based upon my long-term business expectations and stock market valuations, we were holding a portfolio of attractively-valued companies prior to the current declines. The recent declines have only enhanced the overall attractive valuations of our holdings. Had our portfolio been selling at fair value or above fair value prior to the recent decline, I would have been inclined to sell some holdings and be holding higher cash reserves.

Stock market declines, while painful in the short-term can be positive in the long run, at 2 different levels. First, at the BUSINESS level, market drops provide opportunities for well-financed companies to buy weaker competitors, and repurchase their own stock at cheaper valuations. This is where our emphasis on well-financed companies and capable managers who display an ownership mentality should pay off. How, you might be wondering, does a company repurchasing its own shares benefit you as an investor? It only benefits you if the company buys the shares at below their intrinsic or true value. For example, if a company buys 10% of its shares, the business value remains the same but the value is now spread out over 10% fewer shares, increasing the value of the remaining 90% of shares by roughly 10% or so. Second, at the STOCK MARKET level, periodic declines allows me to further concentrate in the best opportunities and the cheapest valuations.

What I've been doing is looking to improve the price to value relationship of our stock holdings by selling stocks trading at 30% discounts to buy more of stocks selling at 50% or greater discounts. So, while there is nothing we can do to prevent these declines, we try to take advantage of the long-term opportunities provided by short-term panic and emotional investor behavior. While not a prediction, most of our top holdings could easily double in value over the next 2 years and still not be wildly over-valued, in my opinion. That's the extent of depressed values currently. What's required of us is PATIENCE, remember, in the short-term the stock market is a voting machine, but in the long-term it's a weighing machine. This is another way of saying emotions drive the market in the short-run, but results drive the market long-term.

One other thing to keep in mind: ALL (AND I MEAN ALL, 100%) investment managers go through periods of underperformance. It's what you do and don't do that determines the long-term impact of short term underperformance. As the doctors say, "first do no harm," so the first thing is don't change the methodology or process that has been used. I'm very focused on maintaining the same process regardless of stock market conditions, and don't sell stocks just because they have declined in value. Sometimes patience is all that is needed - the Morningstar fund manager of the decade (that's right of the DECADE 2000-2010) has had terrible results in 2011, but says he's not changing a thing, which is probably the right approach. He knows that eventually the market will come to its senses and if he's right about the companies and their long-term values, his shareholders will be rewarded. Meanwhile, some of his fund shareholders are bailing out this year because of a lack of patience - doing the wrong thing at the wrong time. Here's a guy who proved to be a very good fund manager over the past 10 years, and yet he is experiencing massive fund redemptions. They should probably be committing additional dollars, not selling out, but that's human nature. Google search for "Morningstar fund manager of the decade" and you can read all the gory details. Warren Buffett has remarked, the stock market is the only place where price declines encourage people to sell.

Our common stock portfolios have declined more than the overall stock market recently; this is so for a very simple reason: with investors fearful of another recession, all economically-sensitive companies are being dumped by investors. Our stock portfolio contains companies that require economic growth to increase sales and earnings. With the economy stumbling lately, our portfolio has been impacted to a greater degree than the overall stock market. Should another recession occur, we will continue to feel the negative effects on our stock portfolios, but the reality is the economy is in growth mode most of the time, so planning for permanent recession is not a good strategy. When the economy regains its footing and we see sustained growth, I would expect to see dramatically better performance from our companies and the stock prices. In short, THERE'S A BOOM OUT THERE SOMEWHERE, AND WE AWAIT ITS ARRIVAL.

P.S.: You'll notice I refrained from commenting about Washington DC, politics, Europe, budget deficits, debt burdens and all of the other messes we currently endure, my philosophy is that these things are out of our control, are always considered when investing, that our companies are capable of surviving these storms, and we have been through far worse in the past century. While I'm not minimizing our current situation, our free market system is still in place and has a way of correcting our mistakes and excesses, which remains my belief.

Please feel free to send me your comments, questions and observations.

-John Heldman, CFA