1st Quarter 2011 Investment Review

"Rumors of my demise have been greatly exaggerated"
-Mark Twain

It's been a nice run, but it appears the party is over. I'm not referring to economic growth, the current stock market upturn or the Los Angeles Lakers' quest for a third consecutive NBA title. In case you hadn't heard, the United States was passed in 2010 in the global manufacturing sweepstakes. Last year China accounted for 19.8% of the world's manufacturing output, nosing out the U.S. at 19.4%, according to a recent Financial Times article. The U.S. held the title from 1895-2010. As the birthplace of the Industrial Revolution, Britain ruled from 1850-1895, and from roughly 1700-1850 it was China.

So China is back on top, where economic historians placed it 300 years ago. While many people would have anticipated China eventually overtaking the U.S., some observers are worried that the changing of the guard is another sign of the long-term decline in United States manufacturing competitiveness. I don't share this view. Consider this: while both the U.S. and China currently produce roughly the same manufacturing output, we use 11.5 million workers to create our manufactured goods. China employs over 100 million manufacturing workers, or roughly 9 Chinese workers for every American worker. Why so many? Simple, our factories are world-class, with sophisticated machinery, advanced production processes and much higher levels of productivity. China has surpassed us largely due to its enormous population, not because Chinese workers are smarter or work harder. To paraphrase Mark Twain, rumors of the death of U.S. manufacturing are greatly exaggerated.

And so, while the U.S. will be required to share the stage with many new players such as China, India and Brazil, I'm optimistic that the competitive challenges will be offset by new opportunities, and the long-term future of this country is still quite bright. Frederick W. Smith, Chairman and CEO of Federal Express (FedEx) put it well in a March article in the Wall Street Journal: "Introducing billions of people into the trading economy is one of the biggest things that ever happened in the history of the world…We are very optimistic about future earnings". Well said, Fred.

I don't spend much time dwelling on day-to-day economic minutiae, because most of it is irrelevant to long-term results and soon outdated anyway. Nevertheless, I've listed on the next page what I believe investors are currently pondering with regard to the current pluses and minuses in the global economy.

NEGATIVES

--high commodity prices (oil/gasoline, metals, grains) due to strong global demand
--continued high U.S. unemployment rate (around 9% currently)
--U.S. Federal and State budget deficits
--rising interest rates (hasn't been much yet, but stay tuned)
--Middle East unrest, Japan earthquake, European government bailouts
--U.S. housing industry remains extremely depressed
--stock market valuations higher, reducing future return potential
--Standard & Poor's changes U.S. credit status from stable to negative
--China inflation increasing, raising global inflation concerns

POSITIVES

--job growth has been much better for the past nine months or so
--Federal Reserve continues to maintain a low-interest rate policy
--U.S. savings rate up from 0% to 5-6% of income, consumer debt declining
--European bank/sovereign debt crisis averted for now; restructuring continues
--U.S. budget deficit reduction plan likely; will be mix of tax increases/spending cuts
--stock market valuations higher but still reasonable
--eventually housing and auto sales will move higher, spurring economic growth

Given the horrible state of the economy and financial markets a couple of years back, the current situation is tolerable. None of the major concerns by itself is enough to derail the current economic recovery, but collectively the world has a lot on its plate. Unemployment, budget deficits and the prospect of rising interest rates are the most pressing concerns.

Our common stock investments continue to be oriented toward companies that benefit from an expanding economy. This isn't a genetic predisposition, it's just where I believe some of the best bargains can be found, particularly in areas that have yet to experience a full economic recovery. Good companies usually go on sale when there are temporary problems. And right now, housing is a big problem in the U.S. So, opportunity is knocking.

The current housing downturn is five years old, and I'm guessing the next five years will be better for housing than the past five years. True, given how bad things are, that isn't saying much. But consider a couple of housing affordability measures. According to the April 11, 2011 issue of *Fortune* magazine, *"homeowners now pay just 9.8% of their income in after-tax mortgage, tax and insurance payments. That's down from 17.2% at the bubble's peak in 2007, and by far the lowest number since 1999. Furthermore, in 28 out of 54 major markets, it's now cheaper to pay a mortgage and other major costs than to rent the same house. In Miami the average rent is now $1,031 per month, vs. the $856 it costs to carry a mortgage."*

This shouldn't come as a surprise, as the combination of much lower home prices and low interest rates dramatically improve home affordability. Now all that's needed is job growth, consumer confidence and lenders willing to make a home loan. One bit of positive news came this month when it was reported that 5.5% of Americans plan to buy a home over the next six months. While this seems low, it matches the record high reached in January 1978.

The United States needs to build over 1 million homes per year to keep up with population growth. We have been building only half that level for the past 3 to 4 years. At current home construction levels the excess supply will eventually turn into a shortage. Most people will chuckle at the notion of a housing shortage, just as most people in 2005-06 thought that homes prices would never decline. The pendulum is starting to swing in the other direction.

So for long-term investors like us, the housing depression creates opportunity. Compelling investment ideas arise when the outlook is horrible and it seems there is no end in sight to the woes. Prices reflect the poor conditions, and a lack of buyers results in low valuations. Our biggest risk is that the housing industry rebound is delayed beyond 2012. If the recovery is pushed out to 2013-14, we'll need to be extra patient. The old saying "patience is a virtue" is really true in the investment game. It's one of our biggest advantages.

Currently most of the portfolios own some or all of these housing related companies:

COMPANY	HOUSING FOCUS
Brookfield Residential Properties	-home builder and developer
MDC Holdings	-home builder
St. Joe Company	-developer, largest private landowner in Florida (~570,000 acres)
USG Corp.	-largest U.S. drywall manufacturer
Mohawk Industries	-largest flooring company in the world
Cemex	-global cement/concrete company
Sears Holdings	-appliances, home furnishings
Ingersoll-Rand	-heating, air-conditioning, home security

What most of these companies share in common is one thing; they are very good at what they do (ok, Sears isn't a world-beating retailer, but its appeal is the real estate value of their store locations, not the retail operations.) They have been in business for decades and have managed to retain their market positions. They'll benefit when housing recovers.

Collectively we haven't made much profit yet with these holdings. But I'm betting the eventual payoff should justify the wait. If I'm wrong, it's in being a little early. But with investments, as in some parties, sometimes it's better to get there early, and leave early.

Webster's Dictionary defines **triad** as "a union or group of three". At the risk of boring repetition (you might remember this from last quarter's letter) I'd like to again emphasize the 3 investment principles Triad employs when evaluating common stocks:

1) Buy *durable* businesses (**Moats**) that can survive a range of possible outcomes.

2) Invest with *capable owner-managers* (**Jockeys**) whose interests are aligned with ours.

3) Pay *less than intrinsic value* by taking advantage of our imaginary friend (**Mr. Market**), whose occasional bouts of irrationality provides opportunities.

Recessions, wars, bankruptcies, political upheavals, natural disasters and occasional stock market declines are just a few of the many events we should expect to encounter. Triad strives to reduce the risks by investing in durable businesses that can survive whatever the world may throw at us, managed by people who have invested alongside of us, and therefore have strong incentives to survive and ultimately thrive. If we invest at sensible prices, our long-term results should be very competitive.

I encourage your comments, questions and suggestions. And I appreciate your patience, loyalty and support. It's a critical element of our long-term success.

Sincerely,

John Heldman, CFA

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