TRIAD INVESTMENT MANAGEMENT

2nd Quarter 2011 Investment Review

"My central principle of investment is to go contrary to general opinion, on the ground that, if everyone is agreed about its merits, the investment is inevitably too dear and therefore unattractive"

John Maynard Keynes, Economist, 1883-1946

"*Finally, it is the long-term investor, he who most promotes the public interest, who will in practice come in for most criticism…For it is in the essence of his behavior that he should be eccentric, unconventional and rash in the eyes of average opinion. If he is successful, that will only confirm the general belief in his rashness; and if in the short run he is unsuccessful, which is very likely, he will not receive much mercy. Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.*"

Keynes, "The General Theory of Employment, Interest and Money" 1935

"Failing conventionally is the route to go; as a group, lemmings may have a rotten image, but no individual lemming has ever received bad press."

Warren Buffett

Lord Keynes (rhymes with brains and gains), as he was later known, was quite an economist. Raised in England, he was one of the most influential economists of the 20th century, developing a branch of economic theory known as Keynesian economics. But adept as Keynes was in economic theory, he was an even better investor. In 1927 he took over management of the King's College investment fund in Cambridge, England. While the fund suffered during the 1929 stock market crash, Keynes' fund rebounded and earned a 9.1% average annualized return from 1927 to 1946, while the UK stock market suffered -1% annual losses over the same period. Keynes' fund was up five-fold over this period while the market was down. So Keynes the investor is worth listening to. Warren Buffett remarked in the Berkshire Hathaway 1991 Annual Report that Keynes' **"*brilliance as a practicing investor matched his brilliance in thought.*"**

Why all the ink spent on a long-dead economist? As the philosopher George Santayana noted, **"*Those who do not learn from history are doomed to repeat it.*"** Keynes was a ***contrarian*** investor, who discovered that betting against the crowd frequently resulted in profitable investments. He wasn't always right, especially in the short-term. His attitude towards long-term investing is revealed in this comment:

"*I feel no shame at being found still owning a share when the bottom of the market comes…I would go much further than that. I should say that it is from time to time the duty of a serious investor to accept the depreciation of his holdings with equanimity and without reproaching himself…an investor…should be aiming primarily at long-period results, and should be solely judged by these.*"

Keynes' approach was to ignore the crowd, take a long-term view and make concentrated bets. His contrarian reasoning was simple; popular investments get bid up in price, and as the entry price increases, the future return potential decreases. Whether the asset is a business, office building, apartment complex or farm, it should make sense that a high starting price lowers the future return, but many investors don't get the connection. They equate a rising price with a bright outlook, and assume the fact that everyone else is buying must be a good sign. But perhaps all that buying and popularity has elevated the price to a level that will result in subpar long-term returns. Of course, some investors know the price is high but assume they are the smarter one who will get out before the good times end. This is the "Greater Fool Theory", that is, the investment will be sold to a greater fool before the price declines. Easier said than done.

Keynes and Buffett's observations' regarding ***conventional failure*** reveals much about the mindset of many investors, who draw comfort from lemming-like behavior. All of the lemmings may go off the cliff together, but if everyone's doing it, it feels good at the time. In the investment world, conventional failure means a professional investment manager won't get fired for buying what others managers buy. Whether that investment is appropriately priced or has potential commensurate with the risks can take a back seat to participating in a "can't miss" investment.

LinkedIn, a May 20111 Initial Public Offering (IPO)-30 million shares traded on the first day, 3.8 times the amount sold to the public; someone was very busy that day-provides a current example of "conventional failure". It's a website for business professionals to network and connect. A good idea, but business success is not guaranteed. However, many investors believe that the "social media" craze (did I say craze? I meant concept) is the next great investing idea, and have invested without regard to the price paid. LinkedIn is currently valued on the stock market at roughly $10 billion (yes, $10 billion), versus revenue in its latest fiscal year of $243 million, and about $15 million in earnings. This is an astronomical valuation and is based on the high hopes that the company grows for many years at a very high rate and increases profits significantly. There is also a pile of 18 million employee stock options outstanding (gotta keep those employees happy), putting an even higher valuation on the company of roughly $12 billion.

Groupon, a potential IPO, is a coupon website offering businesses the opportunity to generate new customers and revenue through internet distribution of discount coupons to large groups of people. It's been suggested the company will be valued at up to $30 billion when it goes public this year. It's been around three years. Coupons? Gimme a break. How sustainable is a coupon business over a long period of time? Already there are dozens of competitors in some markets. No matter, Wall Street is lining up to take the company public.

This isn't investing, it's equivalent to buying a lottery ticket. But as human nature might suggest, many of the Wall Street investment banks who helped LinkedIn go public are currently recommending that investors buy the shares. Conflict of interest? Reminds me of the saying, **"*Whose bread I eat, his song I sing*".** Triad won't be investing in LinkedIn, Groupon, Facebook, LivingSocial, Pandora or any other "hot" concepts churned out by the Wall Street factory. I've seen this movie before, and it ends badly for most participants. But for now, as in other areas of life, there is ***perceived*** safety in being part of the herd, whether you are an investor, a sheep, or a lemming. Meanwhile, Wall Street plays the role of shepherd. It's been said there are two things in life you shouldn't watch being made: sausages and laws. I'd add another: Initial Public Offerings (IPO's) made on Wall Street.

I have no idea whether these businesses will develop into long-term successes. But I know the odds are against most new ventures, ideas, startups, etc. The business world is brutally competitive and has a way of delivering less success than hoped for. It may work out, but it seems like going to Las Vegas and betting on black at the roulette table. When low odds of business success are combined with extremely high prices, a high rate of investor failure usually follows. That's why we ***avoid*** fashionable, popular, trendy, highly-valued investments, and seek unknown, unloved, unconventional, cheaply-valued investments.

"Conventional success" is really an oxymoron, like jumbo shrimp, Congressional accountability or almost pregnant. The dictionary definition of conventional is ordinary, commonplace, conformist. If success could be achieved in a conventional manner, wouldn't investment success be ordinary or commonplace? The results say otherwise; the majority of investors experience mediocre investment outcomes. Because investing unconventionally is at times uncomfortable and lonely, it's difficult for many investors to do. It requires knowledge, conviction, patience, discipline, independence and contrary instincts. Unconventional investors must accept inevitable periods of doubt, uncertainty and short-term underperformance. It's not for everyone (which creates our opportunities), but in my opinion offers better prospects for long-term success.

The quotes by Keynes and Buffett offer the same advice in different ways. To be successful, it pays to adopt a ***contrary*** mindset, which entails investing in an ***unconventional*** manner. That's part of what I believe makes Triad different.

So far, I've discussed some of the investments Triad won't make, such as LinkedIn, Groupon, Facebook, etc. That's part of the process, deciding what ***not*** to invest in. With a potential universe of over 20,000 common stocks and thousands more corporate, municipal and convertible bonds, shrinking the pool is a critical part of the process.

So, what does Triad look for in deciding where to invest? At the risk of excessive repetition, I'll restate the three broad elements we employ when evaluating common stock investments:

1) Buy ***durable*** businesses (**Moats**) that can survive a range of possible outcomes. This means businesses that have been in existence for a reasonably long period of time, with significant market share and demonstrated resilience in difficult economic cycles.

2) Invest with ***capable owner-managers*** (**Jockeys**) whose interests are aligned with ours. Managers whose stock ownership dwarfs their annual compensation pay more attention to shareholders than "rent-a-managers" whose primary aim is collecting a paycheck.

3) Pay ***less than intrinsic value*** by taking advantage of our imaginary friend (**Mr. Market**), whose occasional bouts of irrationality provides opportunities. If we can't find a durable business with capable owner-managers at a below-average valuation, we'll wait until we do.

I've identified several hundred companies that meet the first two criteria; durable businesses with trustworthy owner-managers. Triad seeks to reduce risks by investing only when the price is significantly below my estimate of long-term value. In this regard, our best friend is Mr. Market, an imaginary fellow whose mood swings depict the real-life occasional irrationality in markets, allowing us to buy low and sell high. Despite all the current headlines it's still primarily about Moats, Jockeys and Mr. Market.

Now that I've blathered on about what Triad will and won't buy, what about the current investment environment? While my crystal ball is as cloudy as the next person's, I sense a fair amount of investor gloom and a general lack of confidence. That's understandable, given the long list of worries, including U.S. budget deficit concerns, high unemployment and housing woes, energy prices, the Euro-zone mess (Greece, Ireland, Portugal, potentially Spain and Italy), Japanese earthquake repercussions, China growth slowdown, inflation risks, Federal Reserve QE2 ending, and…well you get the idea. That's the sobering news.

The good news is these concerns are being reflected in below-average stock valuations. Main Street investors continue to shun the stock market, keeping valuations at modest levels. As ***contrarians***, we want to buy when others don't, and sell when others want to buy. Eventually we'll get better news on the economy, jobs and the markets.

With regards to our specific portfolio holdings, I'm optimistic about the businesses we own, the owner-managers running them, and would feel comfortable owning this group for years. Looking beyond the next twelve months common stocks still offer the best combination of return potential and risk compared to bonds and cash. When the outlook changes, we'll change our allocations accordingly.

I encourage your comments, questions and suggestions. And I appreciate your loyalty, support and patience. They are important elements of our long-term success. In return, I feel obligated and guided by a strong sense of responsibility for the funds entrusted to me.

Sincerely,

John Heldman, CFA

July 18, 2011