TRIAD INVESTMENT MANAGEMENT

3rd Quarter 2011 Investment Review

"I am not in the business of predicting general stock market or business fluctuations. If you think I can do this, or think it is essential to an investment program, you should not be in the partnership…We don't buy and sell stocks based upon what other people think the stock market is going to do, (I never have an opinion) but rather, upon what we think the company is going to do. The course of the stock market will determine, to a great degree, when we will be right, but the accuracy of our analysis of the company will largely determine whether we will be right…Who would think of buying or selling a private business because of someone's guess on the stock market?"

Warren Buffett, Buffett Partnership Letter July 1966

Before he assumed control of Berkshire Hathaway and utilized it as his primary investment vehicle, Warren Buffett managed a series of investment partnerships from 1956 through 1970. His comments from 45 years ago remain relevant today, and will be relevant 45 years from now. Indeed, which investor would try to divine the direction of the stock market before purchasing a gas station, delicatessen or hardware store in their hometown? It's all about the business and what you pay for it.

Buffett benefited enormously from studying with and later working for his mentor, Benjamin Graham, a very successful investor and Professor at Columbia Business School. Graham drilled the following into Buffett's head:

"***You're neither right nor wrong because other people agree with you. You're right because your facts are right and your reasoning is right—and that's the only thing that makes you right. And if your facts and reasoning are right, you don't have to worry about anybody else."***

Both of these comments reinforce the idea that the stock market is there to serve investors, but you needn't become a slave to its daily ups and downs. In the long run, fact-based investment decisions grounded in fundamental business analysis will prove to be more important than attempting to guess the short-term outlook for the stock market. In similar fashion Bernard Baruch, another famous investor, also commented, ***"If you get all the facts, your judgment can be right; if you don't get all the facts, it can't be right."***

In many cases today, stock prices have diverged significantly from true investment value. In times like this, it's important to remind ourselves that markets often undershoot and overshoot normal valuations. But if we get the business analysis correct, invest at a discount to that value, and maintain a patient long-term approach, Mr. Market eventually will respond.

While Triad doesn't base investment decision-making on stock market forecasts, we do pay attention to ***current*** economic and business conditions. This is not the same as forecasting the future direction of the economy or stock market. Analyzing current conditions is fact-based, whereas forecasts are an opinion. We observe current conditions to gain insight into where we are in the business cycle, which in turn can provide clues to the general level of investment markets and investor sentiment.

For instance, when the economy is growing strongly, we should expect to see robust consumer spending, high corporate profits, government budget surpluses (remember those days?) and higher valuations for investment assets such as stocks, real estate, private businesses, etc. While these conditions are positive, for investors it's also a time to be cautious, as a rising tide tends to lift all boats. More money is lost in good times through overconfidence than in bad times. It just won't be apparent until the downturn arrives. Increasing confidence can alter the otherwise good judgment of business owners, investors and consumers. For Triad, when boom times return, we'll be looking to raise our caution.

Conversely, when tough times arrive, as they always do, the opposite set of conditions is visible. Consumer and business confidence is lacking, with spending and investment weak. Government budgets are in deficit due to low tax receipts and higher spending on unemployment benefits and the like. Investment markets tend to be depressed as corporate profits are reduced and investors place low valuations on a perceived gloomy or cloudy future. For Triad, short-term difficulties often bring long-term investment opportunities.

While I can't forecast the course of the economy over the next 1 to 2 years, it seems to me that we are ***currently*** experiencing more gloom than boom. Consumers and businesses don't seem optimistic about the future, and that's reflected in depressed stock market valuations, in my view. Investor sentiment is poor, and money continues to leave the stock market for the perceived safety of bonds and cash. Note I said the ***perceived*** safety of bonds and cash. Bonds currently yield very little while exposing investors to principal loss should interest rates rise. And while cash is safe it provides zero return after inflation.

As rational contrarians we should welcome the opportunity to make investments in today's environment at what I believe are ***knocked-down bargain prices***. As Buffett said, the course of the stock market will determine ***when*** we are right, but our facts and reasoning will determine ***whether*** we are right. And so, I focus on gathering the facts, developing reasoned analyses, and leave the stock market guessing-game to forecasters. The good news is I'm finding plenty of attractive investments. Eventually, we'll have our payday.

I've mentioned in previous letters that the day would come when our short-term results would be worse than the overall stock market. That day is here. Our common stock results for the year-to-date are below those of most major stock market indices. I attribute this to two primary reasons:

One, our stock portfolios are more ***concentrated*** than mutual funds or other "conventional investors". We typically own 20-25 companies, versus 100 or more for many mutual funds. Generally, Triad focuses on a concentrated collection of durable businesses when their shares are undervalued due to temporary, fixable problems or general market declines. That's often the only time the shares are significantly undervalued. Patience is required when companies encounter operational issues, and patience is sorely lacking among investors today. Cheap shares can become cheaper, as investors throw in the towel and move on to a stock perceived to have better short-term prospects. If prices decline but the business outlook remains intact, I buy more believing that eventually investors will recognize intrinsic value. Concentration can hurt in the short-term, particularly now when investors are especially nervous, but my belief is that the benefits of staying highly focused on the best opportunities outweigh the short-term volatility. Remember, volatility is not the same as risk. Risk is the chance of permanent capital loss. That's what I'm focused on avoiding.

Two, the stock portfolios continue to be oriented toward companies which benefit from a growing economy, often referred to as ***cyclical*** stocks. That's where the money is in the stock market currently, in companies with the greatest amount of current uncertainty, creating the greatest discounts to true value. With recent concerns about a "double-dip" or second recession, many of the economically-sensitive companies we own--including homebuilders, construction, real estate, manufacturing and energy companies--have endured substantial share price declines; much more, in my opinion than warranted by temporary concerns about the economy. After all, stock prices theoretically represent the value of ***all*** future earnings discounted back to the present at a required rate of return. Not the value of earnings for only the next 12 months or so. But Mr. Market is currently feeling pessimistic and is focused on problems, not opportunities.

Warren Buffett commented about housing and construction in a July 8, 2011 Bloomberg Television interview--keep in mind that Berkshire Hathaway owns or has investments in drywall, brick, paint, manufactured housing, real estate brokerage, insulation, furniture, and carpet companies--all tied to housing:

"There is a natural correction occurring in housing. The only way this correction takes place is to have household formation exceed new construction by a significant amount for a significant period of time. We've had that for quite awhile…When you see these figures of 500,000 or 600,000 housing starts, that means we are sopping up housing inventory. I don't know when exactly it hits equilibrium, but it isn't five years from now, and I think it could actually be reasonably soon."

I'd agree, and with our current investments in housing, construction and real estate, Triad portfolios should benefit over the next few years if he's correct.

But why invest in companies that require a stronger economy to benefit their share prices? As the infamous bank robber Willie Sutton said when asked why he robbed banks: "That's where the money is." Given heightened concerns about the US and global economy, investors have been bidding up valuations of "stable-growth" companies (think food, beverage and household goods like Costco, Pepsi, McDonald's, Procter and Gamble, etc.) and shunning cyclical companies. Hence, "stability" is less of a bargain. And opportunity often is in what others ignore. The key is patience until the economy recovers fully and cyclical companies demonstrate their earnings capability. My best guess is it might be another year or so until the world begins to stabilize and investors feel comfortable betting on stronger growth. But in my view, it should be worth the wait. As I write in mid-October, there has been some improvement in share prices, but the real gains lie ahead.

Below I list our three investment criteria (the Triad); mentioned often, but worth repeating:

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 durable businesses with capable owner-managers at below-average valuations, we'll wait until we do.

Since we are approaching year-end, I'd like to comment on portfolio turnover and capital gains. Our turnover, or amount of buying and selling, has been higher than normal this year. Extremely high market volatility combined with a disciplined selling process, along with my desire to take advantage of opportunities presented by such volatility, are largely responsible for the higher turnover. I make changes ***only*** to improve our prospects, either by upgrading portfolio quality or obtaining a better bargain (selling a 20% discount to buy a 40% discount). Higher turnover has resulted in capital gains in many accounts, mostly due to sales earlier this year when markets were higher. My goal before the end of the year is to reduce taxable capital gains ***wherever warranted by investment considerations***.

I realize that paying taxes is not high on your list of favorite things to do. However, making changes simply to reduce taxes might lessen the long-term portfolio return potential. I'm also aware that 2011 realized capital gains result in real cash being paid in April of 2012. It's a balance and I look carefully at ALL factors, not just the tax liability. Remember, it's always better to be paying taxes than the alternative--generating losses. My goal is not to minimize your tax bill, but to ***maximize the long-term after-tax return*** for each portfolio.

I encourage your comments, questions and suggestions. And I appreciate your loyalty, support and patience. I'm guided by my responsibility for the funds entrusted to me.

Sincerely,

John Heldman, CFA

October 18, 2011