4rd Quarter 2011 Investment Review

"*You can't make a good deal with a bad person*" *Warren Buffett*

The Merriam-Webster dictionary defines triad as "***a union or group of three***". It's no coincidence that Triad Investment Management was founded upon three main investment principles. First, the ***Business***, which I compare to a medieval moat that offers protection from competitive business attacks. Second, ***Management***, which is similar to a race horse jockey. Third, investment ***Valuation***, which is influenced by short-term irrational investor behavior--swinging like a pendulum between bouts of optimism and pessimism.

Staying with the triad theme, client letters have three main purposes: explaining Triad investment philosophies and strategies; general investment education; and lastly, discussing my current views of the economy, markets and investment results. This quarter I'll discuss the importance of corporate management.

While it's hard for lousy management to destroy a great company, it improves the odds of success if you have the right people managing a business. In my book, the elements of management that are most important are ***capability, integrity and shareholder alignment***. If you are fortunate to have all three—and I aim to invest where all three are present--the odds of success are much improved.

Management capability is easier to judge than integrity. Managements usually have a track record of past decisions that can be examined. Integrity is more difficult to assess. Managers can be capable but might also help themselves to an outsized share of compensation (hello Wall Street) or engage in unethical, self-enriching practices. In addition, corporate Boards of Directors are often packed with friends and business associates, resulting in "rubber stamp" decisions, poor independence and weak oversight. Unfortunately the record of management malfeasance is long and sordid, with an endless parade of managers dipping in to the corporate cookie jar. It frequently occurs during prosperous periods when shareholders are less attentive and more forgiving. I attempt to reduce this risk by assessing management's shareholder alignment and incentives to perform. Clues include the amount of stock management owns and compensation incentives that reward long-term business performance.

Perhaps you've watched the cable TV program "*What Not To Wear*", one of my wife's favorites. As the title implies, the hosts advise the "guest" regarding what doesn't flatter her figure, ultimately remaking her entire wardrobe. I was reminded of the program as I read a Wall Street Journal article titled "*It's Déjà vu All Over Again For Perelman, Shareholders".* That's Ron Perelman, the financial equivalent of "*What Not To Wear*". I'd call his show "*What Not To Do With Your Money*". Specifically, not investing in a Perelman-managed business.

Last December Perelman, Chairman, CEO and 43% owner of publicly-traded M&F Worldwide, bought the remaining 57% from shareholders for an "obscenely low" price of $25 per share, to quote one of Ron's less than satisfied fellow shareholders. Prior to the deal closing this same shareholder said he didn't see shareholders approving the deal "anywhere

near this low-ball price." Why did Perelman's bid succeed? Ron controlled 43% of the voting stock, so to get the deal approved he didn't need many more votes. In baseball terms, he was already standing on third base without stepping into the batter's box and facing the pitcher. He effectively transferred millions from shareholder pockets to his own.

Back in 2001 Perelman attempted another deal where M&F agreed to pay $17 for Perelman's controlling stake in publicly-traded Panavision, when the stock was selling for around $4. In this instance, a shareholder sued and the deal was terminated. Egregious? Absolutely. The puzzling question: Ten years later, why would anyone invest in a company run by this guy?

I've had a Perelman boycott in place for well over 20 years, remembering earlier moves he made to enrich himself. He's been involved with public companies for a long time, taking advantage of shareholders who don't study history. Then again, like Charlie Brown as Lucy pulls the football away at the last second, maybe hope springs eternal that Perelman won't shortchange his apparently comatose stockholders. If history is any guide he will likely keep M&F private for a few years and then take it public again at higher prices. Perhaps he can improve on his number 24 standing in the richest Americans list.

Since he is already one of the wealthiest people on the planet, you'd think Ron Perelman has no need to take advantage of fellow shareholders to further line his already ample pockets. You'd be wrong. As Buffett says, "*you can't make a good deal with a bad person*". Perelman is an extreme example of corporate managers acting in their own self-interest. Capable, yet not working for shareholders. Now let's consider less-capable management at work.

Bank of America announced in January 2008 the acquisition of Countrywide Financial for roughly $4 billion. Billions of dollars in defaulted Countrywide mortgage loans, numerous lawsuits and one new CEO later, it's widely acknowledged that Bank of America made one of the worst acquisitions in corporate history. In contrast, Wells Fargo bided its time during the financial crisis and in October 2008, at the depths of the crisis, acquired Wachovia Corporation, a large East Coast bank that got into trouble with souring mortgage loans. Not only was the timing better, so was the price, and it was a perfect geographic fit as Wells had few locations on the East Coast. Wells has had no regrets, while BofA is still mopping up the Countrywide mess. Wells and Bank of America are now the only 2 coast to coast banks in the entire country. Guess which one I prefer and we own? Management matters.

Evaluating corporate management, to use an old cliché, is as much art as it is science. Still, it's an important part of the investment process. Significant management stock ownership is important, but as the Perelman situation illustrates, it won't always protect shareholders. There is no substitute for continual scrutiny of management's decisions to ensure the focus is on long-term business results and shareholder value. Corporate cultures, personal integrity, motivations and other hard-to-define intangibles matter but aren't easy to calculate. Hence, the art part of the equation. As Justice Potter Stewart remarked in a 1964 U.S. Supreme Court decision regarding pornography, "I know it when I see it" also applies to finding good corporate managers.

For our purposes, when I run into ethically-challenged or less capable management I make a note to steer clear. There are plenty of capable, ethical people running companies; why play the role of Charlie Brown in the hope that Lucy won't pull the football away?

Our 2011 investment results were lousy. It's going to happen occasionally, but remember volatility is not risk. I view **risk** as the ***probability of permanent loss***. Just because stock prices fluctuate in the short-term has nothing to do with whether we lose money in the long-term. Instead I evaluate risk as a private business owner would; having no stock market to provide daily "advice" about the value of his or her business, the business owner thinks about customers, competitors, suppliers, inventories, financial resources, etc. Business owners weigh investing in the business and earning a suitable return on the capital, along with the probability of permanent capital loss due to business deterioration or bankruptcy.

That's how I assess risk. The stock market is there to be used: when the entry price offers the prospect of attractive absolute returns we invest. Likewise, when the exit price is sufficiently high that prospective returns appear low we sell. It's as simple as that. As Benjamin Graham, Warren Buffett's mentor--said: "***In the short term the market is a voting machine but in the long-term it is a weighing machine***". Emotions dominate daily stock market activity, but business results dictate the long-term direction. I don't expect clients to be entirely comfortable with short-term fluctuations, but understand that volatility doesn't negatively impact our long-term prospects. Quite the opposite, volatility can ***enhance*** our long-term results if we take advantage of short-term investor foolishness.

Nevertheless, we were adversely impacted last year for these reasons:

First, the stock portfolios remain oriented toward companies which benefit from a growing economy, often referred to as ***cyclical*** or ***economically-sensitive*** stocks. That's where the best opportunities are, in companies with the greatest amount of current economic uncertainty, scaring off most investors and creating the greatest discounts to true value.

Second, our stock portfolios are more ***concentrated*** than mutual funds or other "*conventional investors*". We generally own 20-25 companies, versus 100+ for many mutual funds. Many investment managers suffer from one or both of these conditions: concerned primarily with ***job retention***, or ***lacking enough knowledge and skill***, they over-diversify to reduce volatility and potential loss. In my view knowledge, skill and diligence leads to a well-researched, focused portfolio that can provide above-average long-term results.

So, we experienced the proverbial "double-whammy" last year as we were concentrated in stocks that investors, in ***fear*** mode about economic collapse or malaise, avoided for much of the year. The good news is that as I write in early February investors are experiencing another behavioral flip-flop from ***fear*** to ***greed*** mode and now embracing what was despised only months ago, including many of our holdings. We have largely recovered all of 2011's declines in the first five weeks of 2012. I fully expected an eventual recovery, but the timing is always unpredictable. Asked about stock market volatility, Warren Buffett said "***I'd rather have a lumpy 15% return than a smooth 12%."***

As previously mentioned, we continue to focus common stock investments toward economically sensitive companies, especially housing, real estate-related, and financial companies. Industries that boomed and then collapsed in the 2008-2009 financial crisis. After 4 to 5 years of depressed activity, these areas are finally exhibiting a gradual recovery. Why own these companies? Many investors look through the rearview mirror when

investing, and avoid recent disaster areas. Investor revulsion can create depressed valuations. However, housing, real estate and finance are essential elements of a modern society and economy. The U.S. has a growing population and increasing demand for housing, while the financial system is the economic equivalent of a human circulatory system. You can't survive without arteries, veins and capillaries, and our modern economy will only grow if the financial system functions. I expect these companies to experience better conditions over the next 2 to 3 years. For them, the recovery is just getting started.

Meanwhile, the U.S. economy continues to rebound from the financial crisis and recession of several years ago, with further progress expected in 2012. Tailwinds include pent-up demand for housing and an aging automobile fleet, lifting both of these important U.S. industries. Also, higher Chinese wages--roughly $1/4^{th}$ U.S. levels vs. $1/12^{th}$ in 2004--combined with greater U.S. worker productivity and higher international transportation costs are contributing to a U.S. manufacturing revival. In addition, new technology, drilling and production techniques have resulted in a boom in domestic oil and natural gas production, reducing our trade deficit, creating jobs and increasing U.S. energy security. We are fortunate to live in a dynamic economy where crises do bring change—granted it would be nice to implement changes without crises--unlike Europe dealing oh so slowly with less-competitive economies and the resulting problems built up over several decades.

Overall, I'm optimistic about our ***long-term*** prospects, based upon an improving economy and modest investment valuations. Further, despite price declines during 2011, many of our portfolio companies grew ***intrinsic business value*** and our appreciation potential from current levels appears quite respectable. No, I'm not a perpetual optimist. Major risks include European debt defaults, Chinese economy slowing, and Washington D.C.--always a concern. There will come a time when the ***investment*** clouds darken, but that will be when the sun is shining and the ***economy*** is humming along. Huh? When the economy is stronger, stock valuations will likely be higher to reflect the better conditions. And we will likely pull in our horns and become more defensive and fearful. To quote Buffett one last time "***Be greedy when others are fearful, and fearful when others are greedy.***" That's the essence of contrarian investing, and one of our guiding principles. I look forward to the future harvest from the seeds we have planted today.

I encourage your comments, questions and suggestions. And I don't take lightly your loyalty, support and patience. I'm guided by my responsibility for the funds entrusted to me.

Sincerely,

John Heldman, CFA
February 8, 2012