TRIAD
INVESTMENT MANAGEMENT

2nd Quarter 2012 Investment Review

Investment Thoughts

"*If you are in the investment business and have an IQ of 150, sell 30 points to someone else. You do have to have an emotional stability and an inner peace about your decisions, because they will be challenged. It is a game where you are bombarded by minute-by-minute decisions. It's not a complicated game. It's simple but it's not easy.*"

Warren Buffett, 2009 Berkshire Hathaway annual shareholders meeting

How could investing be simple but not easy? Isn't that contradictory? So it would seem. It's a paradox, which the dictionary defines as "a statement or proposition that seems self-contradictory or absurd but in reality expresses a possible truth".

Now we're getting somewhere. The statement seems absurd but over 25 years of investing experience leads to--along with gray hair--my personal conviction that it's absolutely true. Let's examine its constituent parts. Investing is fundamentally about analyzing and understanding investment values, committing funds only when the price is below intrinsic or true value. So the relatively simpler part is learning how to value investments. Note the analysis is done without reference to stock or bond markets. Markets don't tell us anything about true value, but can offer informed and rational investors the opportunity to buy below true value and sell at or above true value. Markets play servant to rational investors, not master.

However, for many investors, it's quite the opposite. The market is the master, turning a simple process into a difficult game. The not so easy part is the non-quantitative or behavioral aspect of investing. It's difficult to remain rational and unemotional as markets gyrate, newspapers, television and the internet shout at us and some investors feel the need to "do something". It's not easy to stay positive when the crowd is negative, and conversely be cautious when others are too optimistic and overly confident. So it's more about the psychological or emotional makeup of an investor, and less about having a genius IQ. Intelligence can be helpful, but it's not necessary to be Albert Einstein or Isaac Newton. In fact, superior intelligence can be a hindrance, creating complicated analyses and potential overconfidence. That's why Buffett jokingly suggests if you have a high IQ that you sell 30 points. Ultimately I believe investing is 51% behavioral and 49% intellectual.

Healthy investing can be compared to healthy living. Most people prefer good health, and realize that a healthy lifestyle includes proper diet, regular exercise, avoiding tobacco and moderate alcohol consumption. Leading a healthy lifestyle is simple to understand, but emotionally it's not easy. So it is for investing, simple but not easy.

Economic Conditions

The economy continues to move forward, demonstrating neither recession nor strong growth. The financial meltdown aftermath continues to weigh on debt-burdened consumers, and eventually even government will need to rein in spending. Meanwhile, U.S. net worth is being rebuilt slowly, having peaked at roughly $65 trillion in 2007, then dropping to $50 trillion in 2009; it's now around $61 trillion, almost back to its prior peak. However, wealth is very concentrated, and those at the lower end of the spectrum are still feeling the effects of the drop in home values and retirement plans. But real estate values continue to improve, strengthening consumer confidence; Asians, Canadians, Europeans and South Americans are snapping up U.S. real estate. It's cheap, and the U.S. remains a political and economic safe haven.

In addition, higher automobile sales and greater energy independence are more bright spots for the U.S. Technology advances in energy exploration and drilling create the prospect of eventual U.S. energy independence, unthinkable only 10 years ago. We are in the midst of a U.S. shale gas and oil boom which could create up to 1.5 million new jobs by 2015 and total investment of $3.2 trillion over the next 25 years or so. Also, the average automobile is 11 years old as consumers delayed new car purchases during the recession; many can wait no longer and are now in a buying mood.

Headwinds include Washington political gridlock, ongoing budget deficits and troubles beyond our shores. Europe continues to drag its feet on needed structural reform of uncompetitive countries. Rigid labor laws, an extensive social safety net, and bloated bureaucracy was sustainable in a previous era, but less so in a world populated by 1.3 billion Chinese, 1.2 billion Indians, and hundreds of millions more in other countries willing to work for a fraction of European wages. Greece, the poster child for economic mismanagement, has a retirement age of 57, compared to 65 in most advanced economies. Any wonder Greece is in serious trouble? Longer term, Europe is likely to get its act together through a tighter union for country budgets, banking systems and borrowing capacity. The European saga will be with us for quite a while, as the solutions require cultural changes which are difficult to implement, painful to endure, and entail social upheaval. And you thought we had problems.

China has experienced strong economic growth over the past decade, driven by investments in factories, roads, railways, ports, airports, homes, apartments, office buildings and other real estate. A China bubble might be forming, although its size is unclear. China still has enormous needs to modernize its economy, so any slowdown will be temporary. Nevertheless, growth is slowing, from 9-10% per year to 7-8% or lower. Many Chinese cities, previously reliant on land sales to fund budgets, are reportedly selling car fleets and other assets to pay bills. Slower growth in China will result in lower demand for commodities from the U.S. and elsewhere, including steel, copper, oil, iron ore, coal, corn, wheat, etc. Longer-term, China needs to reorient (no pun intended) its economy toward domestic consumption and away from export-driven growth. As China imports more, U.S. exports to China should increase.

Investment Conditions

Common stocks continue to be our asset of choice among available options. Fear remains in the driver's seat, as investors continue to pull money out of stocks and invest in bonds. Since January 2007, roughly $350 billion has flowed out of stock funds, while over $1 trillion, almost 3 times as much, has flowed into bond funds. Investors continue to fight the last war, or remain fixated on the rear-view mirror; pick your favorite cliché. In my opinion individuals are making a mistake in choosing bonds over stocks at this juncture. Many retirements will be shrunken or delayed as investors fixate on the rearview mirror of minimal return in the U.S. stock market over the past decade. What's critical to understand is this: the past decade of lousy results has improved stock valuations, and is part of the reason why the next decade should be better. In the stock market, when it feels bad, that's when you should be feeling good. Put another way, you can have low stock market valuations or vibrant economic conditions, but you can't have both. Baron Rothschild's advice also applies: ***"Buy when there's blood in the streets and sell when the trumpets sound."***

Eventually the pendulum will swing from fear, toward optimism and finally greed. That's when life will get tougher for us. With higher stock prices and a dwindling supply of attractive values, we'll be pulling in our horns and raising cash. Some clients won't like this phase, with the celebrating in full swing. Warren Buffett noted that ***"you pay a very high price for a cheery consensus",*** which means depart before the party gets out of hand. Good times bring higher prices, and higher prices represent higher risk. When greed returns, we'll reduce stock market exposure. It's important for clients to understand this now, long before we arrive at that juncture.

For some time now, I've been beating the same drum with regard to our stock market investment focus. Three areas have represented roughly 40-50% of our common stock investment portfolio over the recent past and merit discussion. The largest is housing and related real estate investments, currently occupying about 25% of stock portfolios. Housing continues to improve, and should gain further momentum over the next several years. Significant underbuilding in residential construction has occurred over the past 5 to 6 years. The excesses of the prior boom have been worked off, and a better balance between long-term supply and demand is at hand. To illustrate the boom and bust nature of homebuilding, annual home construction in the U.S. was running at roughly $400 billion back in 2002-03, and peaked at almost $700 billion in 2006. Today it's at a roughly $250 billion annual rate, below pre-boom levels, and way below boom levels of 2005-2006. Returning to normal home construction levels will contribute to GDP growth and create millions of jobs, and it's ready to happen.

Next, a partner in crime with housing in the prior bubble: Financial services companies, currently 15-17% of stock portfolios: commercial banks, investment banks, insurance companies, etc. They aided and abetted the builders and homeowners during the real estate bubble, and suffered in the housing bust. The pendulum has swung from greed to fear, and investor disgust has created opportunity.

I've been asked occasionally "***Why do you own housing stocks? Don't you realize housing is depressed and won't come back for another 5 years?"*** It's asked diplomatically, but the underlying message is the same; ***"Are you nuts?*** I say to myself, ***"I own them partly because you asked that question".*** Revulsion occasionally equals opportunity.

Lastly, energy, especially natural gas, comprises the 3rd largest area of common stock investments at almost 10% of equities. Natural gas suffers from technology-induced supply excesses; demand will improve as cleaner-burning natural gas is substituted for coal and oil, its competition for electricity generation and transportation.

These three areas are still depressed and I expect business conditions and common stock valuations to improve over time. All three are essential to a modern economy (think homes, checking accounts, loans, gasoline) and demand will increase as the population and economy grows. I like that type of inevitable investment. Unlike, say, oh I don't know…Facebook?

As for bonds, Dan Fuss, a prominent bond fund manager with 50+ years of experience, commented in April: ***"You need to get out of the market risk that's in fixed income and into the company-specific risk you can find in stocks".*** This is a guy that earns a living managing bonds, and he's basically saying don't buy my product. Treasury bonds, high quality municipal and corporate bonds make almost no sense at current interest rates. However, certain high-yield and convertible bonds offer a reasonable relationship between return potential and risks. To the extent that client situations indicate bonds, these areas are where I'm currently seeing some opportunities.

Overall I remain optimistic and believe we own good investments with excellent long-term prospects.

I have enclosed a copy of Triad's Privacy Policy regarding collecting and keeping private your nonpublic personal information. In addition, let me know if you'd like a copy of our SEC Form ADV Part II. Also, please let me know of any changes to your financial situation that might suggest altering your current investment portfolio.

I encourage your comments, questions and suggestions. I appreciate your loyalty and patience and remain focused on the management of your funds.

Sincerely,

John Heldman, CFA
July 12, 2012

"Always do right. This will gratify some people, and astonish the rest." Mark Twain