Second Quarter 2012 Investor Letter

Second Quarter Market Conditions

The second quarter of 2012 was as volatile as many recent investment quarters, but involved bearish shifts which hurt many equity-oriented portfolios worldwide, including ours. Optimism that the US economy was strengthening and could lead the world out of its economic malaise continued to rule into April, but as May and June statistics showed, both the US and world economies were weakening.

April was a weak month for our portfolios, with the majority of financial markets selling off during the first few days but rallying for much of the rest of the month. May, however, was a disaster; stock markets around the world saw strong selling pressure for almost the whole month. June was an up-and-down month, with a huge "down" day on June 1st when a shockingly small job creation number for May sent stock market averages to their low for the year, and another large "down" day in mid-June when the US Federal Reserve Open Market Committee (the Fed) did not introduce expected stimulus. The rest of the month's action was see-saw culminated in the stock market's best day of the year, June 29th, when the markets were buoyed by a perceived compromise by Germany in European meetings. Overall, the quarter was characterized by weakness in financial, energy and technology stocks, offset by strength (actually strong gains) in telecom and utility stocks. The gains in defensive sectors like telecom and utilities (along with smaller gains in consumer staples and healthcare) showed the deterioration of bullish sentiment and the rush for less volatile, higher-payout sectors. We are still astounded at how well the consumer discretionary sector of the market has performed (only down 3% for the quarter and up 12% year-to-date) in the face of pressure on US consumer budgets.

A notable feature of the stock market during the quarter was the damage inflicted on "underperformers." If stocks missed on earnings (even by one penny per share), gave an unexpectedly downbeat outlook, or had operational problems, the stock price was typically savaged for 5-40%! For example, Fossil, the watch and accessory maker, saw its stock price fall nearly 40% in early May on higher earnings that missed expectations by a penny and a lower than expected rise in overall sales. Tempur-Pedic, the mattress maker, dropped 30% in a day in late April and then 50% on June 6, first on a poor outlook and then on a preannouncement of poorer quarterly earnings. These examples (and many others which occurred during the quarter, including Research in Motion) show the treacherous nature of investing in growth companies that then disappoint expectations.

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This quarter, many sectors of the financial markets moved in very different directions – less correlated than they have been in the recent past. Below are discussions of how different markets acted during the second quarter.

Precious Metals

After the huge drop in precious metals prices on February 29th (due primarily to some market players' thoughts that the day's European Central Bank's ETRO funding was the last monetary stimulus possibility for weeks/months) and the weakness during March, precious metals were set to rebound in April. Instead, metals prices essentially mirrored the US stock market, showing market perceptions that metals were more risk assets than havens for capital. Gold and silver stocks underperformed both the stock market and the metals themselves as perceptions grew that the need for metals protection in one's portfolio continued to wane. Also the negative momentum from the February/March sell-off had not yet "broken" in the minds of momentum investors.

The first half of May brought the selling climax, with the metals themselves and the stocks suffering more losses through mid-month, but the buying of physical metals by investors and central banks, coupled with the compellingly low valuations of metals mining stocks, caused the stocks to finally bottom and then rebound. Even the mainstream press noticed how low valuations had become, with articles in the influential investment weekly Barron's and online on marketwatch.com. Falling energy prices (energy along with labor are the two main inputs in the cost of mining) also helped mining companies' fundamentals, helping buoy the stocks.

June saw a higher gold price, although gains were moderated by the Fed's lack of substantive policy changes during their late June meeting. Silver was lower for the month, showing that it is still impacted by industrial demand worries. Both gold and silver mining stocks were for the most part unchanged for the month, exhibiting still-uncertain sentiment from the investment community despite improving fundamentals – still lower energy prices, some merger activity, and continued physical buying by central banks.

Energy

The energy complex was strong in April with West Texas Intermediate (WTI) crude trading between $100 and $106 for the month, while North Sea Brent maintained a $10-15/bbl premium. But May saw the virtual collapse of oil prices as a number of factors conspired to push down prices: 1) poor and worsening worldwide economic statistics, 2) reversed flow direction of two US pipelines, allowing more crude to reach US coastal refineries and driving down prices with more supply, and 3) increased Saudi production (leading to more worldwide supply) designed to reiterate the Saudi's control of the policies of OPEC and to weaken the influence of Iran, their militant Shia rival in OPEC and the Middle East politics / regional hegemony. One more factor that has escaped the press, but we believe also impacted both sentiment and supply/demand factors is 4) Japan's decision to re-start a few nuclear reactors that had been shut down completely since last fall in the fallout from the March 2011 Fukushima disaster. Japan, the third largest economy in the world, has been importing significantly more energy than last year to make up for the lack of nuclear generation. The Gartman Letter in its 6/22/12 issue shows that Japanese usage of fuels will increase year-on-year by 100% for crude oil (+5 mil metric tonnes), 35% for fuel oil (+4 mil tonnes), 21% for LNG (+9 mil tonnes) while coal drops 2% (-1 mil tonnes). Reversal of that policy and the reduced buying by Japan in anticipation of lower summer supplies we think had a definite effect on the market. ***[Late note: only 2 reactors were actually started, meaning actual nuclear generation is still very low compared to prior years]***

Having said that, energy stocks were at low valuations to begin the quarter, so although we were fearful we might see oil prices drop from the $100/bbl mark, we did not think the price drop would affect stock prices as much as they did. Despite the quarter's performance, we still believe investments with long-lived crude reserves will reap the benefits of high crude prices in the future as supply/demand fundamentals readjust in the near future and prices recover. We are less sanguine about oil field service stocks; we believe that services will not be needed for expanded drilling but for maintaining deliverability, due to low natural gas prices and uncertainty over oil prices for the rest of this year.

On the subject of natural gas, the lack of a true North American winter continued to hammer natural gas prices, which reached a multi-year low in late April below $2/MMBtu. As producers cut back on production and plans for new demand (possible usage in vehicle fleets and projects to export US natural gas to high-value markets overseas) crystallized, prices rebounded in May, stabilizing around $2.50 during late May/June as hot weather impacted gas usage throughout the US. We still believe that the glut of current and near-term supply will keep a lid on North American gas prices through 2012 and probably into 2013-14.

Bonds

Longer-term Treasury bonds, which had showed weakness in March as economic statistics reflected some nascent economic strength, reversed in April as economic statistics showed deterioration worldwide and fears of an Asian slowdown intensified. May's poor US statistics led to selling of risk assets and more strong buying of bonds, pushing US 10-year Treasury yields to all-time low of 1.43% (all-time lows in the history of the United States [220+ years of Federal debt], in which the previous low was on April 5, 1946 at 1.54%, according to Bloomberg and the Federal Reserve's Treasury Constant Maturity data). This extreme risk aversion seemed to be the combination of European indecision, Asian slowing growth and a general deflationary depression fear starting to form in some world markets. Counter intuitively, the catalyst to pull back from full panic mode seemed to be the anemic US jobs report on June 1st, leading markets to believe that the US Fed would be forced to bring monetary accommodation in the near future. The US 10-year Treasury ended the quarter at 1.65%, still lower than the lowest yield seen during the financial crisis in September 2008 at 1.69%. The longer-term but less liquid US 30-year Treasury traded on June 1st near 2.50%, while closing the quarter near 2.75%, around its 2008 low yield.

Bonds/Other Markets

Currency markets acted much like stock markets during the quarter, undulating with politics and policy decisions (or indecision). The euro and the US stock market traded almost in lockstep, showing how linked the two markets were, with the prospects for the US stock market dependent on the same forces shaping the euro. The Japanese yen, after weakening in March, recovered some strength in both April and May, strengthening further as risk appetites plummeted in late May. In June, the yen traded in a narrow band, but it still seems vulnerable to weakening, aside from its periodic strengthening anytime worldwide risk appetites drop. "Commodity currencies" like the Australian and New Zealand dollars, were strong in April, weak in May, but strong in June, showing the correlation with risk assets but tempered by the attractiveness of yields in those countries.

International equity markets performed roughly in-line with US indices but performed more poorly in April and did not recover as much in June.

Going Forward

Equities

US equities outperformance in the first half of 2012 appears to have been boosted by the "pushed forward" demand of the historically warm winter (nice weather caused people to spend money they would normally in the spring) and the continued high profit margins helped immensely by low interest rates and low wage pressures due to high unemployment.

This outperformance has stretched valuations in the equity markets so that expectations are high and growth is rewarded, while companies that miss expected results or predict lower forward earnings are punished severely. This happened in the second quarter and continues into the third quarter. Even Apple, which hadn't missed earnings expectations in more than five years, disappointed the markets in July and was hit for more than 5%.

We believe the rest of the year will be characterized by a schizophrenic market, moving up with monetary stimulus and moving down with economically weak results or sovereign upsets from Europe. We believe the Fed will introduce additional monetary stimulus, possibly as early as August but by early September as the US economy continues to weaken and the Fed feels compelled to act far enough before the election in

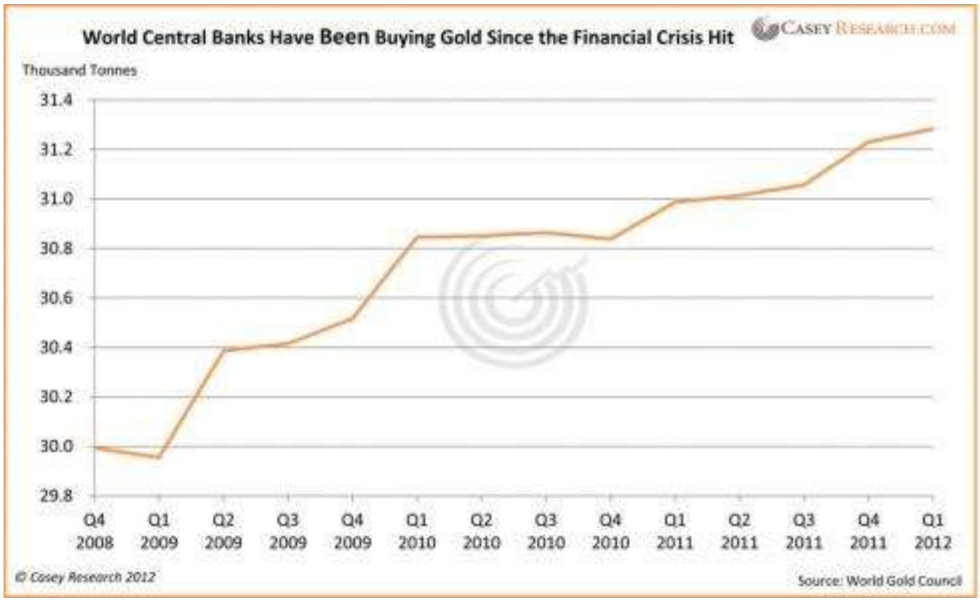
November so as not to be seen as influencing it. We also believe that the market will "settle on" the winner of the election as early as late September or early October, reacting as if the election had been decided at that point. The debt ceiling is also due to be revisited in late August/early September because the US has already outstripped the debt ceiling established in last summer's tortured compromise. All these inflection points point toward continued high volatility, but we expect a market that will not resolve itself going higher or lower until the election is "decided" in the markets.

Precious Metals

Precious metals markets and metals mining shares staged a rebound from their lows in mid-May, but they continue to suffer in early July from a lack of any catalyst to take them higher until late in the month. Both gold and silver have held levels of support during June and through mid-July, and late July comments by Fed "mouthpiece", Wall Street Journal reporter Jon Hilsenrath (predicting more monetary stimulus from the Fed drove up metals prices) and comments from ECB chief Mario Draghi promising measures to keep the euro intact (accompanied by the comment: "And believe me, it will be enough"), continue to underpin gold demand. Also noteworthy, Japan's Bank of Japan (BOJ) increased its asset purchases in April by 10 trillion yen ($126 billion) to a total of 70 trillion yen, buying Japanese ETFs – both stock and real estate investment trusts; the BOJ is the first central bank to have a systematic purchase of <u>private (non-governmental</u> assets. Dennis Gartman in a recent newsletter stated that the newspaper The Nikkei postulates that the Bank is going to spend all the money allotted to buying ETFs (at least 1.6 trillion yen) which while a small portion of the overall program, is a potent force in supporting Japanese equity and REIT prices, while introducing new money into the economy to pay for these purchases. Finally, and possibly most significantly, the Swiss National Bank (its central bank) has continued to try to weaken the Swiss franc though the purchase of euros, increasing its balance sheet <u>by 50% in the 2nd quarter of 2012, almost doubling its euro reserves</u>. This intervention has introduced 125 million new francs into circulation, putting more upward pressure on gold as the worldwide amount of currencies continues to grow. These policy statements show the continued inflationary effects that are feeding the worldwide monetary systems and provide a window into other policies the Fed, ECB and the BOJ might use to provide further monetary stimulus in the future.

Russian Central Bank purchases of gold continued through the second quarter, adding 500,000 oz in May and 200,000 oz in June for a total of 29.5 million oz. According to Bloomberg on July 17, in May, Hong Kong imports of gold, a proxy for Chinese central bank buying, "jumped sixfold to …75.6 metric tons from a year earlier, […for a 2012 total of 315 metric tons,] Hong Kong government data showed…[h]igher physical demand in China is good news for the market," Sterling Smith, a commodity analyst at Citigroup Inc.'s institutional client group in Chicago, said…The World Gold Council has forecast that China will top India this year as the world's largest consumer because rising incomes will bolster demand." The below graph from Casey Research's July 9 *Daily*

Dispatch shows how much gold central banks have bought since 2008. We believe these purchase will continue as more money is created, continuing to support higher gold prices in the future.



Energy

While energy has been volatile recently, with crude prices falling and natural gas prices rising, we continue to believe that supply concerns, bolstered by global unrest, and supported by the increasing difficulty to increase deliverability at current prices, will continue to keep oil prices above $80/bbl in the future. Demand growth, albeit at a very slow pace, is expected to continue in Asia. Meanwhile, the costs of finding and delivering crude remain expensive, especially as more fields are developed in remote locations. While Japan did start up a couple of their nuclear plants, we believe that negative public opinion will hamper the startup of many of the idled plants, causing continued strong incremental demand for hydrocarbons – namely crude, liquefied natural gas, residual fuel and diesel fuel.

We reiterate our belief that natural gas continues to be drilled and discovered in quantities that are keeping prices low. Not only are liquids production economics driving the production of large quantities of natural gas, but drilling/producing dry natural gas to generate incremental cash flow from high initial delivery shale wells continues, in spite of questionable full-cycle economics (i.e. possibly not recovering all drilling and production costs over the lifecycle of the well). We also believe that as weather moderates in the fall, natgas production will quickly fill up storage, leading to deliverability excesses and a visit to the lows of the prices of late spring.

Other Markets

Bond prices have continued to rise in July as continued concern in European bond markets and volatility in worldwide equity markets drives investors to hide in US Treasuries and "safe" European short-term debt. As referenced above, US rates dropped to all-time lows (since the 1790s when US debt was first issued) in early June, and in mid-to-late July, they have dropped below 1.40%. Not only is this below the rate of inflation (thus, in real terms, one's capital is shrinking) but we believe that when the bond market starts to realize that central bank-generated inflation will trump recent deflationary pressures, bonds will show large capital losses as yields move back toward historically higher rates that include an inflationary risk component. In addition, the ballooning US Government debt continues to inject more debt into the markets; we believe at some point this additional supply will also help put pressure on rates as investors demand more yield to offset increased risk.

Meanwhile in Europe, **short-term rates in Germany, Switzerland and Denmark are negative**, meaning financial market participants are willing to knowingly lose money to have the cash parked with German, Swiss and Danish governments. That is some extreme fear.

These worldwide bond market extremes (virtual panic) are not sending the same financial signals as equity markets (which are higher for the year in the US, Germany and a few other countries around the world). Thus we believe that either interest rates will have to rise in the future, especially because of the money creation referenced above, or equity markets around the world will have to fall. We have set up our investors' portfolios so that we will be insulated from large drops in equity markets going forward but are able to benefit from further money creation.

Kanos Quarterly Commentary

Our Methodology And Other Thoughts

After another very volatile quarter, we continue to engage in self-examination to make sure: 1) we have constructed a viable investment thesis, 2) made and continue to make good investment decisions, 3) continue to keep our investors apprised of our thinking, and thus, our rationale behind the composition of each customer's investment portfolio, and 4) stay sane.

Thus, we thought it might be a good time to revisit our methodology for investment decisions with you. In addition, we have included thoughts on deflation and Europe following the discussion of Kanos investment methodology.

Methodology

Our methodology consists of:

1) Examining the political, economic, monetary and debt/deficit climate of the United States and Canada, Europe (and to a lesser extent Great Britain), Japan, China, Russia and Southeast Asia/Australia, and then to a much lesser extent: Latin America, the rest of Asia, and Africa. Obviously that is a large area to cover, so we concentrate on the US, Canada, Europe and China, because those are the countries on which most of the investment world focuses;
2) Studying the supply/demand fundamentals of various investment sectors, looking for attractive fundamentals;
3) Identifying which sectors would benefit from the various investment climates of the countries identified above, and examining the companies in those sectors;
4) Identifying which companies in attractive sectors would be good investment candidates;
5) Judging the risk and reward of each company's valuation, growth prospects, profitability, cash flow, yield and financial strength;
6) Constructing a portfolio with diversified positions but a concentration in attractive sectors and companies to maximize appreciation, yield and risk; and
7) Monitoring markets and portfolios and adjusting positions for factors which would change our investment allocation while trying to ignore the effects of investment preference changes, investment profession effects, investment/consumer fads and our own emotions (when our positions do poorly or very well).

These are judgment calls on our part, where we are judging the probability of success at every level of analysis. Thus, we view investing as a series of probability judgments, adjusting our framework for investing by what we view as the probability of reward of each investment versus the risk involved. Risk means the risk of the company being able to run its business and gain/maintain market share over time with the resources it owns/may realize versus the probability of losing business, having financial problems/severe management problems and a generic factor for unforeseeable events.

Thus, here is our methodology applied to our portfolios, in a nutshell:

1) Examine political, economic and monetary climates:

United States: *Political:* gridlocked/increasing regulation *Economic:* good but fading *Monetary:* easy/need to ease more *Debt/deficit:* large, but currently considered stable
Canada: *Political:* center-right slant/stable regulation *Economic:* good/seemingly stable *Monetary:* moderately easy *Debt/deficit:* relatively large/stable
Europe: *Political:* gridlocked/increasing regulation/politically disjointed *Economic:* weak/ probably recessionary *Monetary:* moderately easy/need to ease more *Debt/deficit:* large, and getting to be unstable in weaker countries
Great Britain: *Political:* center-right *Economic:* weak/probably recessionary *Monetary:* easy/more available *Debt/deficit:* large, currently stable but getting weaker
Japan: *Political:* gridlocked/change difficult *Economic:* weak and fading *Monetary:* easy/need to ease more *Debt/deficit:* enormous, but currently considered stable!
China: *Political:* committee driven/hierarchical *Economic:* good but weakening *Monetary:* stable/room to ease *Debt/deficit:* sovereign stable, but lots of local/private debt
Russia: *Political:* top-driven/hierarchical *Economic:* weakening *Monetary:* relatively stable *Debt/deficit:* low but getting weaker – rising deficits
India/Southeast Asia/Australia: *Political:* obviously diverse/mostly stable *Economic:* stable to weakening *Monetary:* inflation problems/mostly dependent on developed world *Debt/deficit:* deficits a concern
Everywhere else (in general): *Political:* politically disjoint/increasing regulation *Economic:* weakening *Monetary:* dependent on developed world *Debt/deficit:* starting to be a problem, both deficits and debt

2) Study the supply/demand fundamentals of investment sectors:

Energy: *Supply/Demand:* oil - balanced/high, NA natgas - plentiful/moderate, World natgas - limited/high, coal - plentiful/moderate, oil field services - balanced/high *Short-term prospects:* moderating prices *Long-term prospects:* limited supplies at low cost/rising prices *Notable:* worldwide markets

Materials: *Supply/Demand:* precious metals - balanced/high, base metals - plentiful/ moderate, chemicals - balanced/moderate, steel/iron - balanced/moderate *Short-term prospects:* beaten-up, would benefit from easing *Long-term prospects:* limited supplies at low cost/rising prices *Notable:* worldwide markets

Industrials: *Supply/Demand:* aerospace - plentiful/moderate, machinery - balanced/ moderate, builders/building materials - plentiful/low but rising, electrical components - plentiful/moderate, heavy construction - plentiful/moderate, metal manufacturing - disjoint/moderate, textiles - plentiful/moderate, waste/pollution - balanced/moderate *Short-term prospects:* materials, labor costs at risk to rise, slowing demand *Long-term prospects:* strong companies will prosper with growth resumption/higher fixed costs *Notable:* dominated by large countries with expertise/competitive advantage of capital/balance sheets

Consumer Discretionary: *Supply/Demand:* appliances - plentiful/moderate, automobiles and trucks - plentiful/moderate, home furnishings - plentiful/low but rising, office supplies and equipment - plentiful/moderate, paper products - plentiful/moderate, recreational goods - plentiful/moderate, retail stores - plentiful/moderate to falling, specialty food - plentiful/moderate but at risk, textiles/clothing - plentiful/moderate, toys/children’s - plentiful/moderate *Short-term prospects:* materials, labor costs at risk to rise, slowing consumer buying power *Long-term prospects:* strong companies will prosper with growth resumption/higher fixed costs *Notable:* has held up very well over time; may suffer more in a recession.

Consumer Staples: *Supply/Demand:* beverages and brewers - balanced/moderate to rising, cigarettes - limited/falling slowly, cleaning products - plentiful/moderate, food producers - limited/rising, food processors - limited/moderate (due to price), grocery and drug retail - plentiful/moderate, personal products/toiletries - limited/moderate to rising *Short-term prospects:* good yielding, stable businesses, not a lot of growth in volume *Long-term prospects:* brands have a lot of pricing power, valuations of companies stretched? *Notable:* are there any bears on this sector?

Health Care: *Supply/Demand:* biotechnology – high and very risky/rising, diagnostics - plentiful/rising, drug delivery - evolving/rising, drug manufacturers - limited/rising, drugs generic - rising/rising, health care plans - plentiful but uncertain (Obamacare)/saturated, home health care - rising/rising, hospitals - plentiful and uncertain/uncertain (due to high costs), long-term care facilities - rising/rising, medical appliances and equipment - moderate/uncertain (due to high costs), medical instruments and supplies - plentiful/rising (but generic), medical lab/research - limited/uncertain (due to high costs), medical practitioners - plentiful/uncertain (due to Obamacare), specialized health services - plentiful/uncertain (due to Obamacare) *Short-term prospects:* Uncertainties around Obamacare make the whole sector harder to analyze; clearly cost-saving subsectors, like pharmaceuticals and prevention, should be attractive *Long-term prospects:* obviously, the graying of the US and Europe should drive higher demand in home health care, long-term facilities and drugs and medical supplies; Obamacare makes the economics of hospitals, practitioners and insurance very uncertain long-term *Notable:* haven’t done as well as investors thought over time; lately have outperformed.

Financials: *Supply/Demand:* large banks - few/moderating with regulations building, regional banks - plentiful/moderate but rising, life insurance - limited by balance sheets/rising, asset management - plentiful/moderating, corporate insurance - limited by balance sheet/moderate, investment banks/brokers-plentiful/moderate, real estate brokers developers - moderate/rising, REITS - limited/rising due to yield, mortgage - plentiful/moderate *Short-term prospects:* excesses of past leading to more regulation, Federal Reserve is helping large bank profitability, "bonanza" potential still intact *Long-term prospects:* don't know quality of assets, healthy banks needed for eventual future economic growth *Notable:* lots of risk still in sector, daisy chains of trillions of derivatives an ongoing concern

Information Technology: *Supply/Demand:* software - limited sources/high, storage - high/rising, semiconductors - specialized can be limited/uneven, hardware - plentiful/ moderating, computer equipment - plentiful/moderate, internet providers - plentiful/rising with population, computer services – expensive and people-oriented/rising, advertising/social media - limited/high but switchable, networking - plentiful/moderate, security - limited and expensive/rising *Short-term prospects:* lots of great companies producing great products, lots of companies being left behind, "bonanza" potential attractive *Long-term prospects:* innovation leads to lower costs/obsolescence, lower future pricing expectations *Notable:* glamor of new products has masked cyclicality of sector

Telecom Services: *Supply/Demand:* US wireline - balanced/moderate to falling, US mobile - plentiful/rising smartphone demand, foreign wireline - limited/moderate to rising, foreign mobile - plentiful/rising *Short-term prospects:* US-good yielding, stable businesses, foreign-gov't involvement, usually good yielding *Long-term prospects:* higher cost of building out networks, lower future pricing expectations *Notable:* have to balance new capacity and revenues

Transportation: *Supply/Demand:* Air freight - ample/stable Airlines – ample/weak Railroads – limited/strong but moderating Trucking – ample/weakening Containers – plentiful/moderate Tankers – plentiful/strong Dry Bulk – plentiful/moderating *Short-term prospects:* Slowing economy puts pressure on high-fixed cost transports; continued high fuel prices hurt profitability *Long-term prospects:* railroads and shipping are most efficient way of transporting bulk goods, so good future prospects *Notable:* shipping was constrained in late 2000s, so new large efficient ships are entering worldwide fleet, putting continued downward pressure on rates worldwide

Utilities: *Supply/Demand:* US electrical - balanced/moderate to rising, US gas -plentiful/ moderate to rising, US water - plentiful/moderate to rising, foreign electrical -plentiful/ moderate but falling, foreign gas - plentiful/moderate, foreign water - short/rising *Short-term prospects:* US-good yielding, stable businesses, foreign - gov't involvement, usually good yielding, financial uncertainty *Long-term prospects:* higher cost of development/NIMBY problems bad for new plants, foreign - lack of financing a problem *Notable:* great in non-inflationary times; will be hurt by rising interest rates.

3) <u>Match supply/demand fundamentals of sectors with country climates:</u>

We believe that Canada and to a lesser extent the US and Australia combine the best economic and legal stability, coupled with plentiful resources, educated labor and less-invasive governments (although the US government has obviously become more activist in recent years).

As far as sectors, we believe that 1) materials – precious metals, 2) energy – crude oil, 3) pharmaceuticals, 4) consumer staples, 5) telecom services and 6) software are the most attractive. They all have long-term favorable supply/demand characteristics, have the prospect of pricing power (essential in an inflationary environment), limited competition (mostly due to scale, large capital expenditures and long lead-time projects) and are essential economic components.

We believe sectors that are less attractive are: 1) retail (especially textile/clothing), 2) technology (especially hardware), 3) financials (especially large US/European banks), 4) many consumer discretionary (especially vehicles).

Some sectors, especially utilities, industrials and transports, are capital intensive and subject to long payback times for large facilities – in light of economic uncertainties and possible pricing pressures, we believe these sectors are not as attractive until worldwide economic growth is reaffirmed.

4) <u>Identify companies in attractive sectors:</u>

While we don't have the time and space to get into security analysis of each of the companies in the attractive sectors, we generally look at the following elements: 1) profitability, 2) valuation multiples (P/E, P/CF, P/B, etc.), 3) dividend yields and their sustainability, 4) sales trends, 5) future growth potential (either in sales or profitability), and 6) balance sheet condition/amount of debt. Valuation and the ability for the company to prosper in the future are our main concerns.

5) <u>Judge the risk, reward and financial aspects of each company:</u>

This is subjective but usually involves checking out what the company or companies in the sector (or related sectors) have done in the past, how they have fared, what risks have impacted them, and seeing whether those factors would hurt or help the price of the targeted security in the future.

One risk that has a large bearing on our portfolios is the risk of a rising dollar. Commodities are priced in dollars, and companies selling products overseas in non-dollars and translating those transactions into dollar-denominated profits are sensitive to the strength/weakness of the US dollar. We have to judge the risk of a rising (or falling)

US dollar in relation to its effect on our portfolios and how strength/weakness will affect our portfolios positions in the future.

6) <u>Construct a portfolio:</u>

We attempt to buy at least two companies in attractive sectors, weighting our capital commitments to the more attractive sectors. We also try to keep some cash on hand to help stabilize the portfolio and to have "ammunition" for attractive investment opportunities as they present themselves. If we are fearful about market, sector or regional impacts on our portfolio, we will be inclined to have a hedging position against our equities to offset some of the volatility of the markets. And we will often invest in exchange traded funds (ETFs) if we believe there are attractive macro-economic opportunities in non-equity investments such as currencies (we have invested in the Australian dollar and against the Japanese yen lately), commodities (some portfolios contain ETFs that invest in precious metals bullion, agricultural crops, etc.) or interest rates (ETFs that benefit from movements in long-term interest rates, for example). We have invested in bonds and bond funds for clients, but with rates so low, we are shying away from bond investments due to the perceived risks of higher rates, reinvestment risk [buying at "the top"] and default risks. In a more normalized investment climate, we would have a larger allocation to yield through fixed income.

7) <u>Monitor markets and portfolios and adjust positions:</u>

We believe that following our methodology and taking a longer-term view will preserve your wealth, while keeping up with (or hopefully out in front of) inflation. We also want to capture scarcity or innovation when we believe the opportunity is at a reasonable value. Unfortunately, the strategy exposes us to short-term volatility, which has been much more extreme since 2008. However, we believe holding great companies that contain long-term value will build our customers' wealth over time.

In spite of the length of the above Methodology section, we have also included some thoughts on important themes that are impacting the financial markets. The three topics are: 1) Deflation? More Probably Inflation, 2) Europe: What are the possibilities? and 3) Government Gone Wild?

Deflation? More Probably Inflation

We continue to be a bit confused by the concern of many world investors about a deflationary depression. While they have occurred in the past, there are a number of factors that, to us, argue against that result happening in our present situation, in spite of the large debt levels built up worldwide.

John Mauldin, in his book, <u>Bull's Eye Investing</u>, does a good job of defining deflation:

> ’Deflation’ is a broad-based decline in general prices over time that results from a decrease in the quantity of money in relation to the available goods. It generally is known to occur when there is a general money supply contraction. Deflation can often occur following a period of excess supply or capacity beyond demand with a pervasive psychology of delayed spending or due to economy-wide debt reduction (or debt destruction). This digression onto deflation is important because the laws of financial gravity pull in an opposite direction once an economy crosses the threshold of zero….

Gary Shilling, most notably, but many other economists have been arguing that we are in a deflationary situation and point to falling long-term Treasury rates as the primary indicator. We believe that the “deflationists” are right in that: 1) banks have had to delever from their pre-2008 levels, which means shrinking balance sheets (as loans are redeemed and debt paid off), potentially causing a drop in money supply, 2) there is extra capacity in manufacturing and labor worldwide, potentially putting downward pressure on prices, and 3) consumers in the developed world, especially Europe and the US, are in aggregate saving more than during the 2000s, paying off debt and spending less, dampening demand for goods and services.

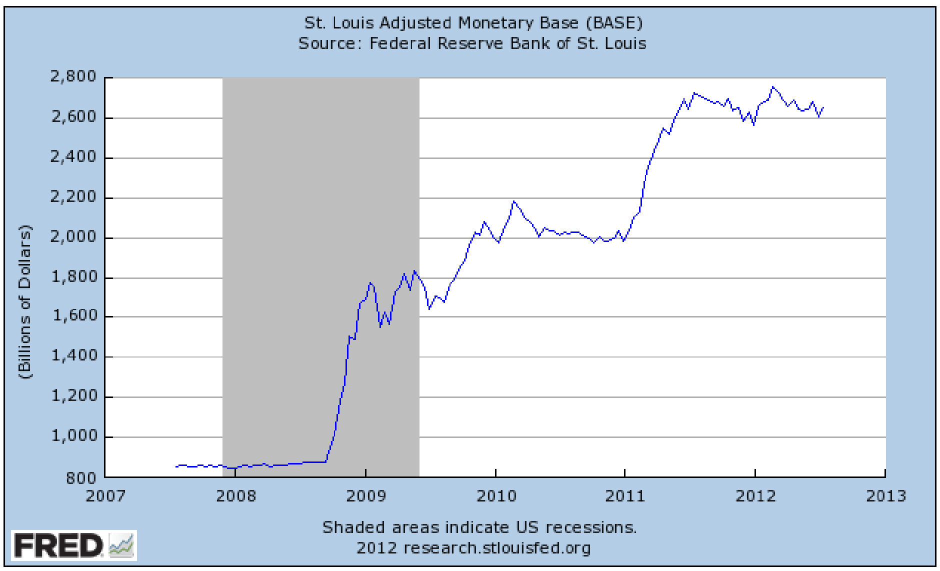
But we believe that accommodating central banks worldwide have fought off much of the developing deflationary pressures worldwide, and that central bank policy makers will use their monetary powers to ensure inflationary pressures are applied until deflation is “defeated”. This is best characterized by the now famous speech given by [then Fed Governor] Ben S. Bernanke before the National Economists Club, Washington, D.C. on November 21, 2002 titled, “Deflation: Making Sure ‘It’ Doesn't Happen Here”. In it he argues that the US economy is resilient enough to withstand deflationary shocks and that the US Federal Reserve has a lot of monetary “weapons” and the will to use both conventional and non-conventional tools to fight deflation. The most famous passage of the speech is this:

> “…U.S. dollars have value only to the extent that they are strictly limited in supply. But the U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost. By increasing the number of U.S. dollars in circulation, or even by credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services. We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation.”

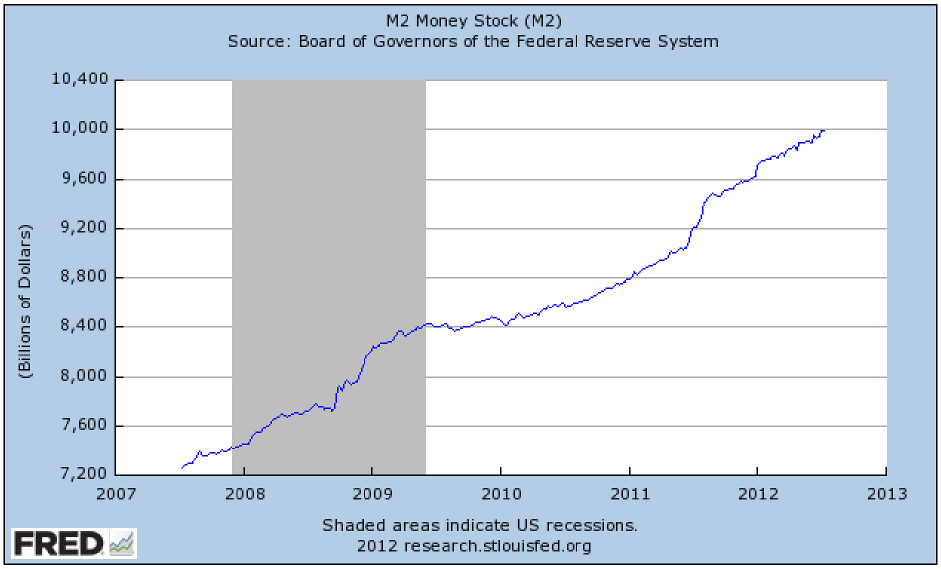
Thus, the now-Chairman of the Fed is of the firm belief that he can always generate inflation, and he has already headed a Fed that has taken what were formerly unconventional tools (quantitative easing, lending to foreign banks and corporations during 2008, etc.) and used them to combat financial crisis and potential deflation. The Fed has recently reiterated its price stability mandate by declaring its inflation target to be 2%, not its inflation ceiling. With current Fed readings of the inflation rate (the Consumer Price Index) reading 1.7% (and Fed surveys indicating future inflation expectations are anchored at a similar level), we expect the Fed to continue to implement policy to ease monetary policy to stimulate the moribund US economic growth and try to boost employment.

We believe that there is already plenty of inflation in the worldwide system, and here are some of the reasons:

First, while the Fed's Adjusted Monetary Base, which is cash in circulation and the money banks keep on account at the Fed until they need it, has not grown since the end of "QE 2" June 2011 (see chart below from the Federal Reserve).



However, at the same time, M2, which is the money supply definition that measures bank deposits, has continued to grow, and looks to have accelerated during 2012 (see graph below from the Fed).



We believe that the Fed has made more money available to the banks than they needed in the past three years, and they have left "excess reserves" at the Fed in the form of M0 [first graph], using what they needed over time, which is shown in the second [M2] graph. The Fed was worried about liquidity, profitability and the ability for banks to draw on a virtually-endless amount of dollars when it instituted QE1 in early 2009. They instituted QE2 in 2010 when the US economy looked to be stalling (much like it is now). In both instances, the Fed made a large pool of money [the larger Adjusted Monetary Base] available, and the banks have converted those excess reserves into money (measured as M2) as they've needed it over time.

Fed rhetoric and past writings show that it is not only used to implementing active monetary policy, that it believes that it may now be the only way to stimulate the US economy (due to the virtual stalemate in Washington cutting off any possibility of fiscal stimulus), so we believe the Fed is ready and able to act, and it will do so sooner rather than later. ***[When we were going to press, the Wall Street Journal's Jon Hilsenrath, considered the newspaper conduit for the Fed, wrote an article on July 24th emphasizing how concerned the Fed was about faltering economic conditions and how many Federal Open Market Committee voters were inclined to vote for more monetary stimulus in August or September].***

And although the Fed does not believe wholesale price inflation has made its way into consumer prices, a number of natural resource prices have climbed back near their 2008 peaks over the past 3-4 years, with oil back in the $80-120/bbl range (not seen since 2008), copper holding in the $3.25-$4.25/lb range, gold still higher on the year and over the past 11 years, and agricultural prices at very high levels with drought occurring in the US Midwest, southern Europe and India (much lower amounts of monsoonal rains).

Finally, and amazingly to us, in spite of deleveraging personal balance sheets, the US consumer has continued throughout the winter/spring to buy discretionary goods, like clothes, at what we believe to be an unsustainable pace, thus boosting the US economy last winter (which had great weather), but "stealing" demand from this spring/summer. If the consumer retrenches, we believe that will also spur the Fed to more stimulus. The continued slump in housing hasn't helped out consumers. We believe the Fed's mandate toward job creation / lower unemployment would be helped by higher housing prices, and we're surprised the Fed hasn't done more to overtly try to cause higher housing prices, by buying more mortgage bonds and pushing down mortgage rates, and by causing general inflation which consumers will rationally react to by investing in the largest real asset they can own – a house.

As a "kicker", we believe the Fed will implement further monetary stimulus because the Fed will be needed to buy future US Treasury debt issuances. There seem to be fewer natural buyers for Treasuries, as they provide virtually no income and seem to be bought by US and foreigners for safety instead of yield. As the US government continues to borrow increasingly large amounts of money, borrowing needs will continue to increase, and the Fed seems to be the natural buyer for increasingly large amounts of US debt that must be sold. The Fed has been doing so through QE2, Operation Twist 1 and Twist 2 (which runs through the end of 2012), but with those programs being relatively small in size compared to the $1 trillion deficits that the US has generated since 2009, the Fed will almost certainly be a big buyer of Treasury debt.

Thus, we believe that the Fed believes that there are plenty of reasons to implement further monetary policy, and that their efforts will accomplish their goal of generating inflation, thus forcing the investing world to switch their investment concerns to inflation, much as it was in the 1970s.

Europe: What are the possibilities?

We have closely monitored the European financial and political situation over the past months, trying to discern the possibilities of how the various situations in countries might eventually be reconciled.

First, a little history: the relative calm around the weakening and eventual late 1980s breakup of the Soviet Union allowed a true peace dividend to be delivered to Europe. Outlays for defense obviously could be cut as the direct menace for Germany (and to a lesser extent, France and the UK) fell away. In addition, Russia and the former Soviet Republics became trading partners and suppliers to Europe, lowering costs and raising the availability of supplies. Finally, cheap labor also entered the European work force, sending prices of manufactured goods lower due to cheaper input costs.

Germany moved immediately after the breakup of the Soviet Union and reunified with the former East Germany, absorbing the debts, converting the weak "Ostmark" into the strong Deutschmark, and employing and re-educating the East German workforce, and rebuilding the infrastructure. Germany ended up spending an estimated 1.3 trillion euro-equivalents (or approximately $1.9 trillion) in the reunification (according to an IWH research institute study in 2009). This huge cost was far higher than originally thought, especially considering the 1985 GNP of East Germany was estimated to be only about $160 billion (CIA statistical estimates). In the end, the "making whole" of the Germans, plus the influx of cheap, unskilled labor was considered a boon at the time to increasing German competitiveness and key to faster growth in the German economy.

The resulting economic situation also seems to have been a key driver in Germany's push toward helping achieve a European monetary union: the costs of German reunification were high while the Deutschmark stayed strong, weakening the German international economic competitiveness in the 1990s. The monetary union creating the euro allowed the Deutschmark to be "watered down" by the other currencies of Europe, pushing Germany to be much more competitive in the market for goods in Europe. Specifically, the chronically weak Spanish peseta and Italian lira became euros, meaning those countries (as well as other EU monetary union members) paid Germany in a stronger currency than in the past, which did not need to be converted, and which allowed the Germans to expand their economy faster than if the Deutschmark were still in existence. This "instant competitiveness" allowed the Germans to grow more quickly than in the past, and to recover the ballooning costs of German reunification as well as to capitalize on the emergence of East Asian economies (led by China) and their demand for European products.

Of course, eventually, the less competitive economies of Greece, Portugal, Spain and even Italy had more and more trouble buying German goods as their economies grew more slowly and generated less wealth than the booming German economy. Germans grew rich, and the PIIGS (countries mentioned above) had to resort to borrowing to finance economic growth. This obviously came to head when growth dropped precipitously following the 2007-2009 financial crisis. Now these structural imbalances are exacerbated by high debt levels, while they cannot devalue the currency to restore cost competitiveness. Thus, the weaker countries in the European Monetary Union are facing high debt, high deficits with no plan for devaluation / debt restructuring to be done wholesale to restore competitiveness.

So, what are the possibilities of resolution?

Anatole Kaletsky of GaveKal Research in Hong Kong in a recent article titled "What Will Germany Do?" argues that Germany is the natural choice to withdraw from the Euro and European Union, leaving the southern European countries the ability to devalue the Euro and allow them to become more competitive. Germany is "the odd man out in terms of economic structure." He argues that Germany only has 2 of the 23 votes at the

ECB and that even with allies Austria, Finland, Slovakia and the Netherlands, could still be outvoted 6 to 17 to ease policy, which could force Germany to leave. A German exit would create a "more viable common currency for the countries of the remaining Eurozone, and …a break-up of the euro caused by Germany's departure would be very bullish for virtually all global risk assets, with the obvious exception of German export and bank stocks."

We agree with Mr. Kaletsky on virtually all of his points, believing that a German exit would be the most expedient way to put European countries on the road to recovery. However, we also strongly believe it will not happen; why? 1) economically, Germany's export and banking businesses are their lifeblood, and no German official, Merkel or someone else, is going to sacrifice those two industries to "solve Europe" – if Germany revived the Deutschemark, they would be much less competitive versus products produced in the Eurozone; 2) Germany was one of the architects of European unification, and as argued above, has profited immensely from it; we don't think they will abandon that position voluntarily, and 3) Germany sees itself as the savior of Europe, so "abandoning" the euro would no longer allow them to shape the future of Europe, which a job in which they are currently in charge and calling the shots.

Thus, the only viable endgame is that the weaker countries will be gradually kicked out of the euro, causing confusion and legal headaches as they try to unwind this "tangled web". The first large casualty will cause the most pain for the world – when Spain or Italy leaves, those large economies will be difficult to decouple from the euro structures. However, these countries all have governments and central banks – those were not discontinued with the euro commencing, so the ability to have structure in place to function is remarkably intact. Greece will probably be the first country to leave the euro, followed in rapid succession by Portugal, then next by Spain and finally by Italy. We are not sure Ireland is going to leave because they have already started the painful process of healing and are more competitive economically than the other countries. France may actually leave in the future, as its economy is remarkably uncompetitive compared to some of the other European countries.

The European Union does not want to break up, as Mario Draghi's July 26th comments attest: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. ***And believe me, it will be enough [emphasis mine KS]."*** But we believe that regardless of resolve and money being used as "band-aids", long-term the structure does not work. Thus, countries will have to leave. The financial markets will almost certainly roil when Greece leaves, and there will certainly be upheaval when Spain leaves. After that, it will be much less disruptive as the market becomes comfortable with countries leaving and the process that each will go through to re-establish their own currency and economic equilibrium. It will not be easy for Europeans in the countries leaving the euro, as their standard of living will fall, even from current levels. But it should lead to economic bottoming, the ability to be more competitive and the economic means to start to employ the vast number of unemployed in Europe currently.

Government Gone Wild?

We are deeply troubled by the continued push of the US Government into all facets of its citizens' lives. While we support government in its essential duties, armed forces, police, fire, infrastructure and some others, we also believe that government doesn't do some things well at all, like education and regulation of industries in which it has inadequate expertise.

We were struck by a recent article, **Biofuels battle ignites again** by Zain Shauk, from the Houston Chronicle about the US Environmental Protection Agency's mandate for cellulosic ethanol in motor fuels. While we understand that some bad behavior has caused more and more need for oversight by government agencies like the EPA, activist administrations, like the current one, sometimes overstep their bounds, especially when the policies don't make sense (and may generate fraud as noted in the final paragraphs):

> "A government mandate meant to boost renewable fuel use has left gasoline makers on the hook for buying biofuels that don't exist, a leading energy industry trade and lobbying group alleges in a federal lawsuit.
>
> In the suit filed late Tuesday in the U.S. Court of Appeals for the District of Columbia, the American Petroleum Institute argues that the Environmental Protection Agency's requirements are unreasonable. "EPA's unattainable and absurd mandate forces refiners to pay a penalty for failing to use biofuels that don't even exist," Bob Greco, the API's director of downstream and industry operations, said in a statement…..
>
> The EPA said it is requiring the purchase of cellulosic biofuel because of a policy mandate to stimulate production of that and other alternative fuels. This year the agency is requiring gasoline producers and importers to displace 0.006 percent of their total gasoline production with the purchase of cellulosic biofuel. The requirement is based on projections that nearly 8.7 million gallons of cellulosic biofuel will be produced this year.
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> As is the case with other EPA-supported biofuel incentive programs, biofuel makers can sell a credit to gasoline producers for each gallon of biofuel they make, and the gasoline makers can use the credits to meet their renewable fuel obligations. But cellulosic biofuel never has generated any credits, according to the agency. In the absence of credits, the EPA allows gasoline producers to purchase cellulosic biofuel waiver credits at 78 cents each to meet obligations at the end of the year.
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> Oil and gas lobbyists argue that the incentive program will require refiners and importers to pay for 6.6 million gallons of the "nonexistent biofuel." The agency has mandated cellulosic biofuel credit purchases since 2010, but absent such credits, companies had to buy waiver credits from the government at a total cost of about $14 million over two years, Greco said in an interview. "That's, in effect, a tax," Greco said. "We're having to pay for a fuel that doesn't exist when the EPA could have adjusted the mandate to reflect that reality." The EPA mandates are based on projected production, but none has occurred, Greco said.

> The American Petroleum Institute filed a petition with the agency last year, asking the EPA to reconsider the 2012 mandates because of the limited availability of cellulosic biofuel. The agency denied the petition and has stuck with the mandate with the intent of creating an incentive for more production of the fuel. The industry group argues that the agency should base its mandates on at least two months of actual cellulosic biofuel production. "This approach would provide a more realistic assessment of potential future production rather than simply relying on the assertions of companies whose ability to produce the cellulosic biofuel volumes EPA hopes for is questionable," the API said in a statement.
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> Other renewable fuel mandates have succeeded in stimulating production and consumption of alternative fuels.
>
> Because of the premium offered by renewable fuel credits, small biodiesel producers have sprouted up nationwide, converting used cooking oil and animal fats into a fuel that can power cars and trucks. But the biodiesel credit trading program has been tainted by widespread fraud. So far the EPA has found that three supposed producers of biodiesel were not producing the fuel at all and were simply generating credits on computers and selling them to large energy companies that needed to meet government mandates. Biodiesel traders estimate that as many as 15 percent of biodiesel credits may be fraudulent."

The absurdity of these government mandates, absent a political motive, is obvious. There is no economic incentive for companies to make cellulosic ethanol, but refiners have to buy credits from the government anyway. And fraud is springing up because the government is handing out money, apparently with less-than-effective due diligence if the industry estimates as much as 15% fraud.

The Managers of Kanos Capital Management