



### Excerpts from First Quarter 2012 Report

“Normal markets are forward-looking usually by at least six months to a year. However, in our opinion, prevailing market sentiment is decidedly myopic. Presently, there is a tale of two markets being told: there is the in-favor, large-cap, momentum-driven portion of the market; and another market for unwashed, inexpensive companies which appear to be getting even cheaper....To us, this is the area of the market which is masking the true breadth, or lack thereof, of the stated averages (with the performance of one stock equating to some 20% of the entire rise of the S&P500 in the first quarter).

We thought we would never see the lunacy of 1999-2000 again, but recent times have suggested that we are in a period similar to that which featured hot IPOs, stocks with lofty P/E's, and creative comparative valuation metrics. Like you, we suspect we know how this ends, even if others fail to do so. The allure of possibly getting rich quick has temporarily overtaken the sobriety on which long-term returns, not to mention reputations, are either solidified or destroyed.

Why do we stubbornly stick to fundamental valuation and sum-of-the parts analysis? We have noticed in the past that when near-term thinking rules the day, it may be because the market sees the longer term and does not like what it possibly bodes. The market response is to live for today, ride the momentum of the most liquid of names, hope the sun rises in the east, and avoid getting bogged down in the long-term. In our opinion, this is what is occurring now, and is the reason why most of the current market action seems to be concentrated in just a few large companies.

Possibly the market is eyeing the end of the current capital gains tax rates, the potential for higher dividend taxation, a revamping of the estate-tax situation, the US Presidential election, the financial problems in Europe, or a lack of clarity on the highly-anticipated QE3. It may also believe that the financial system could melt down and is on a hair trigger alert if in fact a catalyst surfaces (again). So every day that goes by whereby the worst is not recognized, Wall Street can perpetuate the illusion of real money management under the guise of “investing” in stocks that they can quickly monetize if and when *it* hits the proverbial fan.

Not surprisingly, therefore, we receive mixed messages from market commentators every day. We see a report that Europe is going to collapse within two months, and the next pundit talks about how this is a once in lifetime opportunity to buy stocks. One article states that the monetary authorities are standing by to pump as much liquidity into the system as it needs regardless of the circumstances, while the next news item posits that there is no way politically that the Fed can embark on another round of quantitative easing, especially in an election year. Even though we fully promote the spirit of the free market and are normally unfazed by this level of cross current, we cannot help but consider the magnitude of the stakes if we follow the short-term crowd and are wrong.

Why do we think this? Because without QE, low interest rates, trillions in European Central Bank liquidity and daily interventions we think the monetary system as we know it would freeze up.

Considering it at its essence, the future of EVERYTHING, not just markets but the entire way of life in the free world has been reduced to an all-or-none bet that there is and will always be, a geometrically expanding monetary base available to service debt, spend at deficits, bailout countries, pave over sins, avoid tough political choices, fulfill past promises, and retain social order.

Under this assumption, it is no wonder that the market views the future as narrowly as it does the present. Without passing judgment, all people in all countries, regardless of the level of asset ownership, have entrusted the allocation of their currencies to the very same people who choose to exploit it as either a weapon or as a pacifier. That is why, in our opinion we have companies with hyped-up business models attempting to come public before a financial crisis emerges. The potato, as it were, is getting very hot and the insiders and private equity folks don't want to be left holding on too long.

The all-in bet has another unsavory dynamic to it – the assumption that the Fed, ECB, BOJ, etc., are and will continue to be, the spigot that fuels unlimited currency into the equity markets. Under such a scenario, one must own something, be it stocks, bonds, real estate or any asset class that will act as a terry-cloth for all the excess cash anticipated to be printed in the future. Is there wisdom in this, or is it pure fallacy? After all, *everyone* knows that the central planners would never want to promote policies that result in systemic stress, right? As a result, the only conclusion the market can logically draw is that the printing presses will run full bore for a long, long time.

HOWEVER (there's always a however) what the crowd may be missing is the inconvenient fact that the Fed has repeatedly stated that there will be no QE3 for now, but that interest rates will stay low through 2014. (How they know what the economy will look like in 2014 is sort of a mystery to us, by the way). The problem for the Fed is that their credibility has been strained as much as its balance sheet has. That people *think* dollar devaluation is in the wood is apparently all that counts.

To see what's coming up, we need look no further than the inexplicable market alchemy that was employed during the most recent unfolding of the Greek debt crisis. The relief rally resiliently chugged along despite a scenario in which the entire world was ostensibly faced with the same issues yet again. But somehow, by either miracle or *deus ex machina* lower financial minions were propelled into saviors of an otherwise dire and hopeless situation staving off death just in the nick of time. Does the world owe European central bankers a debt of gratitude? Hardly. We now ask whether the world will fare as well, and whether the statist will be prepared to deal with the next country or other entity with a cash flow shortage. The structural problems associated with too much debt, too little cash flow, too many entitlements and not enough political capital have been in no way resolved, **anywhere**. Can any of us really believe what happened in Greece will not occur anywhere else?

Of course not. Unfortunately, questions like this are merely the logical offshoot of a world in which we allow politicians to make economic decisions instead of individual market participants. As such, it is time to call a spade a spade. Nothing has changed in 2012, other than that asset prices of a select corner of the marketplace are higher than they were in December. The aforementioned banks are still plagued by derivatives and toxic pieces of paper, nations are still fending off bankruptcy at best, and have been placed into *de facto* receivership at worst. Washington and other capitals are still

accelerating massive debts and deficits, while seemingly no one on earth is addressing the fundamental changes required to bring the world back to the sustainable equilibrium of present and future. The paper printers still hate gold and silver, but for now view its fans as annoyances. If anything has changed, it is that the market is seemingly relieved that the world as we know it didn't end (this time)..... We just don't believe a darn bit of it and we stubbornly refuse to break our conditioning to finally embrace that this time it really is different.

Possible Silver Lining?

So what's the punch line this time, you ask? If the overall equity markets are poised for a sustained advance, we hope that such a rally will be broader based than this more recent one. This past rising tide lifted only some boats, but we anticipate that greater economic visibility, decent earnings, and favorable business conditions will ultimately emerge one day....If the technocrats cannot (or will not) hold the *status quo* or at least kick the can past the upcoming US elections, then we will attempt to capitalize on opportunities in the event that our investments are priced at even cheaper valuations than we feel they already trade at today."

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