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Excerpts from Quarterly Report written by Investment Partners Asset Management – Q3 2012

This quarter's update is intermittently set to the tune of "Throwing Stones" by the Grateful Dead

"Need that cash to feed that jones…"

There was a study conducted at Wake Forest University in 2008 in which the behavior of dominant and subordinate monkeys was examined relative to their individual proclivity for drug use. The researchers found that dominant monkeys, even under tremendous stress, were less likely to seek narco-stimulation than their submissive counterparts. More than an interesting anecdote, we bring this to your attention because we believe our markets have devolved into a laboratory with eerie similarities to that of this monkey-behavior experiment.

Collectively, the investor class has been relegated to submissive status to central planners and the political technocratic elite. Like the monkeys, we anxiously await the next opportunity to choose between obtaining healthy nourishment from organic growth, or getting that quick monetary fix. Our present market is indeed stressful, and that angst is only temporarily alleviated with the announcements of further quantitative easing or deficit spending – aka expedient political "solutions". Of course the art of politics never trumps the laws of economics in the long run, but they suppose there's no harm in trying.

So, the perceived "rewards" from the stock market herd investors from across the risk tolerance spectrum into equities, because no meaningful income can currently be found in traditional low, no, or even negative interest rate bonds. There are excellent reasons for the evolution of our markets into this paradigm, revolving around the rewards and punishments perceived by the players. When interest rates are artificially dampened by Fed, ECB and other central planners, it leaves investors with seemingly only one alternative – imparting capital into the equity market. This thesis performs well when there is a constant flow of new money into it. Without cash to "feed the jones", though, it falls upon its own weight when sufficient earnings are not generated to support valuations. This is the reason why the clamor worldwide for more easing, money printing, and more time is indeed becoming pitchy.

"Singing I got mine and you got yours…"

What we've seen over the past few years is that the "high" from each QE fix tends to wear off quickly. No sooner have the monkeys chosen narcotics over food, than they begin panicking about when they can expect even more potent drugs in successively higher quantities. While the debate over whether this strategy can be sustained has become more vociferous domestically, in the rest of the world its din is deafening. The cadence of the rhetoric at home will likely turn even less civil if in fact the fervor for the equity alternative diminishes as the US economy faces the so-called fiscal cliff. In fact, we may be seeing signs of possible waning in the few trading days since the US presidential election.

Truthfully, we see little difference between the US economic plight and that of the PIIGS nations (to say nothing of the financial affairs of state and local governments.) The challenge is the same for municipalities, states, countries, and continents - too much debt, not enough cash flow. Eventually, instead of political debate surrounding transfer of wealth from private citizens into government coffers, the "mine and yours" debate will swing toward that of minimizing political damage associated with required austerity measures. We suspect that this, as we have learned in Europe, may NOT be pretty.

"Picture a bright blue ball just spinning, spinning free….."

Recently we have been treated to more quantitative easing (to get the mortgage market just right), a temporary trading halt in the stocks of not one but two technology bellwethers, the demand from Germany for the return of its gold from the Fed, and treasury rates at inconceivable lows.

It is for these reasons, we prefer to invest in companies and funds with underlying tangible assets, cash, cash-flow, and/or earnings potential. Simply put: we think that the continuous dilution of the dollar and its purchasing power suggests a long-term inflationary bias.

"There's a fear down here we can't forget, doesn't have a name just yet…."

Given the backdrop described so far, it is not surprising that there are a myriad of what historically would be incredible "buy low" circumstances in a number of sectors of the market, in many parts of the world, in various industries……seemingly all over….everywhere*.*

In the past year, the headline numbers in the averages bear little if any resemblance to many sectors of the market. There has been limited if any, real business activity to provide a catalyst for meaningful near-term value creation measures – particularly in the micro, small and mid-cap spaces. It is as if the world remains on hold, possibly until after the election whereby, under normal circumstances, there would be an enormous pent up demand for mergers, acquisitions, corporate actions, *something.*

We believe that the inertia of the middle market, and the starvation of capital for microcaps are the leading casualties of the "crowding-out" conditions. It is for this reason that the markets are littered with enterprises that sell for a fraction of what it cost to develop them, or a miniscule multiple of what they presently generate in cash flows. To break this log jam we think it will require some confidence on the part of business leaders who may still be haunted by the 2008-2009 experience. They probably think, rightfully, that with the fiscal cliff on the immediate horizon - history may not repeat, but it might just rhyme. As such, managers are supremely risk averse to advance their enterprises and possibly create value. They resoundingly are sticking with the devil they know and eschewing the devil they don't. Even large and middle-market investment banks (often catalysts for corporate-finance initiatives) are cutting back staff and in some cases disappearing altogether.

Given this environment, corporations which, to us, appear valuable on a number of levels curiously find themselves with depressed valuations. We suspect this dynamic will likely linger for a while – with businesses favoring liquidity over capital formation, and market participants favoring trading over investing - until some of the unresolved economic and tax issues are dealt with. Frustrating as it may be, it is the path of least resistance for now.

"And the politicians throwing stones…."

And that brings us to the great purveyors of indolence. Nowhere are there better stewards of this new world order than in Washington, DC. We suggest strongly that virtually nothing that these guys and gals (in both parties) formulate to address the fiscal cliff will ultimately benefit the investor class. Your taxes are probably going up. Your risks, in the short term, for holding assets are probably going up. The size of government is probably going to increase. And the political turf battles will make business conditions more onerous than they are now. By the way, we'd probably be saying precisely the same things if that other guy had won.

"The future's here, we are it, we are on our own….."

If the current political, economic, and business climates may not be favorable for value creation, what can be done in the meanwhile? Well, on the one hand, those headwinds can be a blessing because sometimes they create opportunity from decreased expectations and lower valuations. On the other hand, those same daunting forces can work against investors when managements and boards of companies, despite evolving conditions, entrench and resist change to unlock value for shareholders.

As you probably know, we tend to take an active role on behalf of our investors' interest. While we prefer to be fervent advocates on behalf of our portfolio companies, we realize that circumstances may cause us to become agents of change from time to time. We believe boards and managements should listen to their shareholders. If they don't, we may take the necessary steps in an attempt to unlock value, perhaps even joining the board to make our voices heard among other shareholders. We envision continuing with this stance, and we expect that soon even mainstream Wall Street firms are going to pick up on this theme as well. In our opinion, for too long money-management firms have taken a laissez-faire attitude towards the managements and boards of their holdings. Ultimately, they need to remember that companies are run for their owners' benefit – and, in the end, value has to be created by someone.

So, while we head into the newest investing era (marked by curious monetary policy, political disputes, uncertain taxation, fiscal cliff negotiations, and gridlock in the capital markets) we will simultaneously be attempting to find unique opportunities and, on a case-by-case basis, endeavoring to unlock value on your behalf.

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