ADDING VALUE

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Daniel Kahneman, winner of the Nobel Prize in Economic Sciences and author of a new book, Thinking, Fast and Slow, challenges our rational model of judgment and decision making. He defines two operating systems—System One (the fast thinker) and System Two (the slow thinker). While Kahneman may not connect the exact dots between his economic theory and investment management, the idea of two operating systems working simultaneously in our brains will ring true, especially after a year like 2011.

YOU MISS 100% OF THE SHOTS YOU DON'T TAKE.
-Wayne Gretzky

Fortunately, 2012 has started on a much better note than the dizzying and daunting market volatility that was experienced in 2011. Everyone, ourselves included, is sleeping better, reacting slower, and thinking harder. The first quarter of the year is also the time for receipt of annual market letters from noted investors. Several have caught our attention this year because of the surge of ideas, suggestions, critical thinking, and evaluation concerning today's political and market environment. Without further ado, what follows are some important ideas from the managers and ourselves for 2012.

Seth Klarman's Baupost Group Annual Letter covered a wide range of topics from fixed income yields, equity prices, volatility, leverage and investment behavior. While we are unable to invest in Mr. Klarman's funds, his observations are always notable. For instance, his comments on current yields are:

"*The absence of yield in the developed world is unprecedented since the Great Depression, yet investors are becoming acclimated to, and probably dangerously complacent about, today's low interest rates, which can hardly be a permanent condition. The 30-year Treasury returned a whopping 22.8% in 2011, as yields fell to 2.9% at year-end; 10-year U.S. Treasuries ended the year at a 1.9% yield. Such scant yields are certainly inadequate recompense for the long-term commitment of capital in the face of soaring U.S. government debt and printing presses that never stop cranking away.*

Many investors use the anchor of the "risk-free" interest rate to tether their valuation models. Even though riskless investments have never really existed (there is no such thing), the conventional wisdom has been to consider U.S. Treasury bills a proxy for a risk-free investment. All investors, to some extent, think about return relative to what they could earn while taking "no risk." Today, with all sovereign debt under suspicion – and for good reason – even a traditionally slow-to-act rating agency has figured out that U.S. government securities are not without risk. While in our view the possibility of a default by the U.S. is remote because all of our debt is denominated in our own currency, and we would inevitably print money to meet all our obligations under any circumstance, the ensuing currency debasement would hardly be risk-free to holders of medium or long-term U.S. government debt. With no

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"risk-free" rate to guide them, and government interest rates across the yield curve being manipulated by quantitative easing, investors are no doubt finding it harder than usual to get their bearings."

In addition to Seth Klarman's comments on fixed-income yields, Warren Buffett and Larry Fink of BlackRock, a huge firm that offers a wide variety of bond investment, both suggested that investors should strongly avoid Treasuey debt and concentrate on equities. Bill Gross, the manager of the largest bond fund in the world, reported in mid-February 2012 that he increased holdings of U.S. Treasury debt to about 38% of his asset base. It seems as though some things are not going to change in 2012 - namely, strong differences of opinion among well-known investment managers. Such diametrically opposite recommendations imply that at least one well known money manager is going to be dreadfully wrong. From our analysis, we agree with Klarman, Buffett, and Fink, although interest and principle will be paid "like clockwork" over the life of the bond, we are afraid that the bond income will fail to cover the loss in buying power due to inflation. It appears that investors are sure to earn meaningful negative **real** returns in Treasury debt over the coming years. We would surmise that this will become a major problem for some aging boomers.

At year-end 2011, it also appeared to us that stocks were attractively priced, primarily because investors were so hell bent on safety. Through year end, investors continued to shift capital out of stock funds and into bond funds virtually every month in 2011. Many of our clients were disconcerted with the relative and absolute underperformance of their portfolios in 2011. It is always a fine line between providing "customer service" and catering to the preferences of scared investors. We try hard to walk this fine line of listening to your concerns while not falling into the trap of reacting incorrectly to the "group think."

One of the more controversial managers, for which everyone had an opinion, was Bruce Berkowitz of The Fairholme Fund. He doesn't beat around the bush. The first line in his 2011 annual letter is: "*What a horrible year for performance! Market prices plunged in many of our Funds' core holdings in spite of strengthening book values with huge reserving for legacy issues....If the yearly change in The Fairholme Funds' NAV reflects perceptions of future performance and if changes in underlying book values of portfolio companies approximate current economics, then markets in 2011 expected disaster in the midst of strength. Improving book value levels and ratios show companies recovering from tough times, prepared for uncertainty, and capable of profits without excess leverage. The Fund's performance last year makes little sense in light of such positive trends and we can only hypothesize from public comments that investors did not fathom our financials' assets…In great years, we asked shareholders not to be swayed by short-term performance. The same is true in a bad year. One circling of the Sun is too short a time to differentiate between good and lucky."*

Similarly, another criticized manager in 2011 was Mason Hawkins. His 2011 Letter to Shareholders begins with: *"As the largest shareholder of the Longleaf Partners Fund, we are not pleased with these results. We are, however, highly confident future returns should be exceptionally rewarding because of the quality of the businesses we own, their prospects over the next five years, and the compellingly low prices we are paying for them. This unique collection of opportunities would not exist had there not been the*

macro fears and resulting high market correlations in the third quarter that damaged 2011 results."

Like Bruce Berkowitz and Mason Hawkins, many of the managers in your portfolio are "high-conviction" managers. Most are cautious and defensive, but also opportunistic. Today, many have a strategy of holding portfolios of concentrated stocks and high cash. Flexibility, patience, and discipline remain the key elements to their capital deployment. Despite the number of actual and imposter "rocket scientists" who have flocked to the investment business, securities prices aren't subject to Newtonian principles, only behavioral ones. Most of us like a stock more when it has risen in price and less when it has fallen, even though this is antithetical to its investment merits, which can only be determined by comparing price to underlying value. We believe that the managers in your portfolio are very rooted in comparing price to underlying value.

2011 was a year in which our firm and some managers were out of sync with the market expectations, but not necessarily the "value proposition" in both the equity and the fixed income markets. Therefore, it is gratifying to see how the portfolios are unfolding in 2012. In this regard, there is a relatively new book Thinking, Fast and Slow by Daniel Kahneman, a psychologist who won the Nobel Prize in Economics for his work challenging a rational model of judgment and decision making. In his book, Kahneman divides the brain into two parts: System One, the fast brain, is mostly on autopilot, processing millions of inputs on a daily basis. This part of our brain forms quick and mostly reliable opinions. It allows us to navigate the world, but it is prone to leaping to conclusions. It harkens back to our caveman days. System Two is the slow brain. System Two is needed to process complicated problems like 17 times 24 versus simple problems like 2 times 2. In our fast-paced world, slow System Two is sometimes given a backseat to the fast, but intuitive System One, when both are needed as a team in the front seat. The System One brain dominated thinking in 2011. Or, as Michael Santoli comments in the 3/19/12 issue of Barron's: "the investment business traffics in too many pat stories and unexamined assertions."

Seth Klarman, again from his annual letter, expounds on this idea: "*Understanding how our brains work – our limitations, endless mental shortcuts, and deeply ingrained biases – is one of the keys to successful investing. At Baupost, we believe that it is sometimes easier to predict how investors will behave in certain situations than it is to predict a company's bottom line. At times of market extremes, by avoiding emotional overreaction and remaining aware of our biases, it may be possible to know market participants better than they can know themselves.*

How can we improve our thinking? Kahneman, notes that the voice of reason (System Two) may be much fainter than the loud and clear voice of an erroneous intuition (System One). Questioning your assumptions is unpleasant when you face the stress of a big decision; more doubt is the last thing you want when you are in trouble. We would all like to have a warning bell that rings when we are about to make a serious error, but no such bell is available. It turns out that it is much easier to identify a minefield when you observe others wandering into it than when you are about to do so yourself. Observers are less cognitively busy and more open to information than actors.

Investing lies at the intersection of economics and psychology, the place where net present value meets greed and fear. It is important to know the numbers – but that is not sufficient. And it is important to know how people think – but that, too, is not enough. Both matter; it is, of course, good to buy investment bargains, but it is far better if you know why they are bargain-priced. Kahneman helps us understand some of the reasons why markets can be inefficient and thus why bargains exist.

Failures in rationality driven by biases can combine with market failures caused by man-made constraints, leading to opportunity for those not so biased or constrained. Since all of us have predispositions toward certain biases, no one should be confident that they are immune from irrational behavior from time to time. Our hope is that by being aware of this possibility, by working as a team with a robust investment process, and by avoiding self-imposed constraints and bureaucracy, we will be able to take advantage of opportunities dished up by others, while minimizing the possibility that our own behavior leads to costly mistakes or foregone opportunity."

Awareness, investment research, and mitigation of behavioral biases are our constant accomplices as we try to always deliver strong relative and absolute performance with minimal risk. The news media and other sources are giving us information daily direct from the System One brain; we continue to strive to overlay the more complex analysis from our System Two brain to make better decisions.

Please call with any and all questions. We appreciate your confidence in our judgment.

Sincerely,
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