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Dear Investor,

Your account is off to a strong start for the year, participating in the upside of US stock markets despite being only partially invested in stocks.

At quarter end half of your account was invested in common stock with the balance allocated to lower risk securities. These include corporate bonds and preferred stocks. Your account is keeping pace with the market, despite its lower exposure to stocks, because on average the stocks we hold outperformed the market. Strong outperformers included Old Republic International, Macquarie Infrastructure, EDAC technologies, and Entravision. All were up more than 20% for the first quarter.

Notes on the S&P 500 index and the outlook for stocks

It has been an unusually strong start to the year for the S&P 500. But with the index recently setting a new all-time high, a number of investors are asking if stock prices are now likely to decline, as they did following the market peaks in 2000 and 2007.

I don’t think anyone can predict short term movements in the market. However it’s worth noting that current earnings of the S&P participant companies are substantially higher than they were at the prior two peaks. As a result, the multiple of price to earnings (PE ratio) is substantially lower than at the prior peaks. The current price earnings reading of around fifteen is towards the middle of where the market has traded historically. In addition interest rates are much lower than they were in 2000 and 2007. All else equal, lower interest rates support higher prices for stocks.

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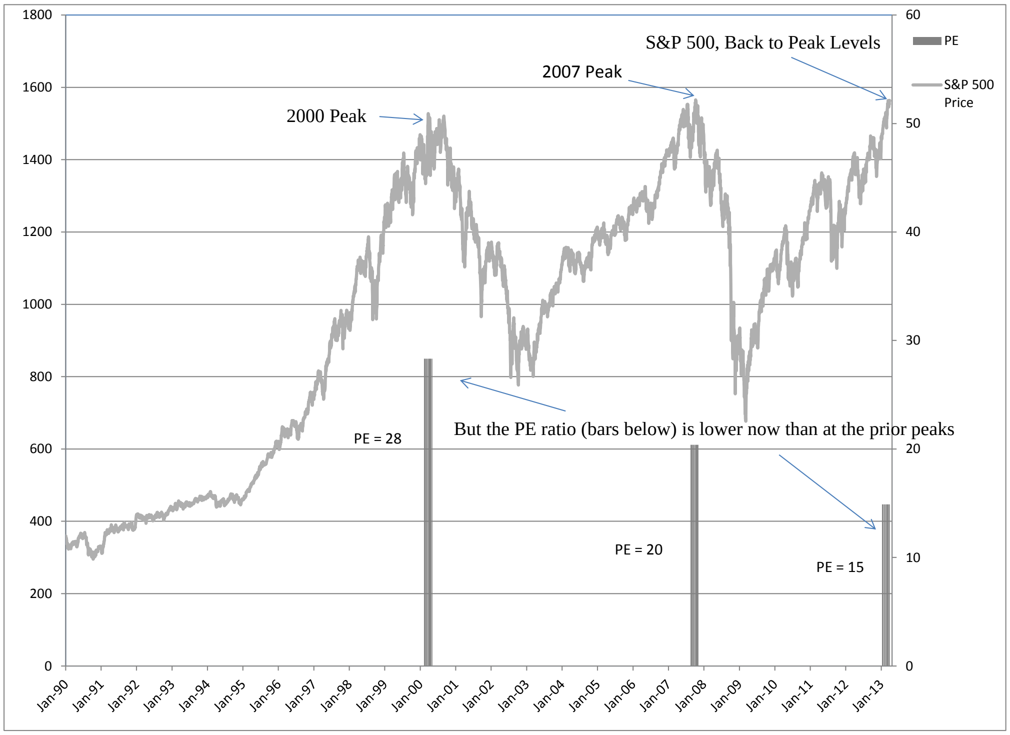
S&P price/earnings multiples (the three solid bars below), are lower today than at the last two peaks:



Source: Yahoo Finance and Standards and Poor Inc.

The high earnings of companies in the S&P index results in part from historically high profit margins (the amount of sales that turn into to income). These margins reflect several decades of improving productivity and slowing wage growth, in addition to higher prices in certain industries (health care being a good example).

Some market skeptics believe the current high profit margins are unsustainable. The most plausible argument for this is that over time corporate cost savings get passed on to customers as a result of competition.

I think some margin compression is likely over the next few years. However I don’t expect a notable shift this year. In fact, some of our holdings are likely to expand margins this year. Macquarie Infrastructure, for example, continues to raise the prices it charges for oil storage, even as its costs remain relatively stable.

There are still plenty of risks to investing in stocks. These include the potential for worsening economic turmoil in Europe, a more pronounced economic slowdown in China, a military confrontation with Iran, and a greater than expected impact from reduced US government spending. Each of these events has the potential to reduce US GDP growth, and in some combination could send the US economy back into recession.

I continue to think the best way to balance the higher potential returns from stocks with their greater potential volatility is to maintain a relatively balanced allocation to stocks, shorter maturity bonds, and longer duration income investments, including long term bonds, preferred stock, and real estate investment trusts. The relatively high level of income generated by your holdings allows for reinvestment at higher expected returns during market pullbacks. And holdings of short maturity bonds and cash provide a reserve for opportunistic investment on pullbacks. Over the last several years, this approach has led to less volatility than the broader market, while continuing to achieve returns that have been comparable to or better than the market.

Notes on Individual Holdings

Last month EDAC Technologies, a small manufacturer of discs for jet engines, agreed to be acquired for just over $18 per share. EDAC, which I have written about in detail in the past, has more than tripled in value over the last two years, and has been an important contributor to portfolio returns for longer term clients. EDAC's sale provides us with an attractive exit value.

We added this quarter to holdings of Entravision, an owner of Spanish language television and radio stations in the US Sunbelt, including Texas, Florida, and Nevada. Entravision's stations provide a targeted means of reaching Hispanic voters in key presidential swing states, as well as states with changing congressional and gubernatorial dynamics. As the 2012 election to some extent demonstrated, it is increasingly difficult to win elections without appealing to a segment of Hispanic voters. This is particularly true in states like Texas, where Hispanics now represent more than a third of the state population. I believe Entravision will be a significant beneficiary in years to come of the massive influx of funding for political advertising that has followed the Citizen's United decision.

We also added this quarter to holdings of RAIT Financial Trust (RAS), a real estate investment trust (REIT) with investments in commercial real estate and commercial real estate mortgages. The value of RAS shares has risen substantially since I began purchasing the stock a few years back. The rise is a result of the company's strong recent earnings growth, as occupancy has improved at RAS's portfolio of apartments, offices, and shopping complexes, and default rates have fallen on its portfolio of mortgage loans. As further support for its stock price, the company's dividend has been increased in recent years to a current yield of 6%. All indications are that the commercial real estate markets in which RAS competes continue to improve. Barring an unexpected reversal in these markets, RAS' stock will continue to provide attractive income and potential for capital gains.

As always, let me know if you have any questions.

Doug

Note: This information is intended as a discussion of past account performance and investment strategy. It is not a recommendation to purchase any specific security or type of security. An investment in securities involves the risk of loss.