July 10, 2011

Dear investor,

Account performance remained positive through the first half of 2011.

As discussed below, I remain cautious on the broader market, but do see selected opportunities in oil and natural resource companies, fee oriented financial stocks like Bank of New York, and a few small cap stocks, such as US Lime Corp. I will be adding to these positions in coming months.

Market Notes

In my year end 2010 letter, I described a number of risks to sustained global GDP growth, which could in turn depress corporate earnings growth. The risks included:

1) Protracted high unemployment.
2) The potential for further declines in housing values, particularly if interest rates rose.
3) Strained state budgets, leading to reductions in state spending.
4) Governmental funding risks in Greece, Ireland, and Portugal potentially leading to large losses for debt holders, including a number of large European banks.
5) Longer term budgetary concerns for developed economies including Japan and the United States, potentially leading to higher interest rates.
6) High levels of consumer debt leading to lower consumer spending.

These risks remain, and global GDP growth has been slow, although positive. Despite that backdrop, US corporations continue to report unusually strong profit growth. S&P earnings grew 20% last year and are expected to grow in the low teens this year, well above expectations for low single digit US GDP growth. The wide disparity between corporate earnings growth and economic growth in the United States is unusual and in combination with low interest rates helps explain the strong US stock market performance since late 2009.

Factors which have supported relatively strong corporate earnings growth can be split into two categories: factors boosting sales, and factors supporting cost reductions.

Factors boosting sales:

1) Emerging market sales growth. While domestic sales are growing at rates consistent with US GDP growth, sales to China, Brazil, and other developing nations are growing far more quickly. As a result, total sales of U.S. companies are increasing, with emerging market sales becoming a larger part of companies' total sales base.
2) Inventory replacement. Corporations allowed inventories to fall to low levels after the 2008 credit crisis, requiring replenishment over the last two years.

3) Government deficits and stimulus. Unemployment insurance and targeted spending programs have provided consumers with some additional spending power, supporting corporate sales in domestic markets.
4) Commodity price inflation. Corporations that own natural resources, or benefit from their extraction, are recording windfall sales from near record commodity prices.

Factors supporting cost reductions:

1) Outsourcing: US corporations continue to reduce labor and benefits costs by outsourcing overseas.
2) Productivity enhancement: Labor reducing technology has improved productivity. In addition, corporate layoffs may have left workers doing more for the same pay. Wage inflation remains low due to excess labor capacity (high unemployment).
3) Low interest rates have allowed corporations to minimize borrowing costs.

Going forward, there will be less growth from inventory replenishment and government stimulus and less room to cut costs. With that as a back-drop, it will be even more important to focus investments on companies benefitting from specific secular growth drivers, such as the growing global demand for food and resources, or on companies whose valuations are based on overly pessimistic assessments of future growth. It is an environment best suited for extremely selective risk taking and a good deal of caution.

As always, please contact me with any thoughts, questions, and concerns.

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.