July 6, 2012

Dear Investor,

Your account remains solidly positive for the year, although down a few percent from last quarter. The drop was largely due to broad market weakness in May, which impacted several of our stocks, particularly those in industrial businesses. I discuss specific holdings in more detail in the last section of this note ('Notes on Specific Holdings').

The quarter was one of substantial volatility for financial markets. The Russell 3000 index fell close to 10% in May, in response to weakening global economic data and continued fears of a disorderly breakup of the European Union. Then in June that index recovered more than half its losses, partly on hopes for further monetary stimulus from the Federal Reserve, and partly on hopes that Europe would solve its economic problems.

Your holdings continue to have less price volatility than the broader stock indexes as a result of their diversification among stocks, preferred stock, and bonds. Preferred stocks and bonds have had less volatility during this period, as investors have sought out investments that provide predictable income.

Economic Outlook

Both world and national developments during the second quarter appeared to me to heighten the risk of a US recession. In response I shifted portfolio mix further towards lower risk investments.

The European Union continues to struggle with the problem of a shared currency without a fiscal union. Unlike the United States, where the federal government distributes some portion of taxes from economically successful states like Connecticut and New Jersey to economically weaker states like Mississippi, there are few transfer payments among European states. That absence of shared fiscal support and shared banking support, combined with limited cross border labor mobility and the absence of substantial monetary easing by the European central bank, is deepening recessions in Southern Europe and Ireland. Those deep recessions make the survival of the EU in its current form precarious.

If the EU does break up, it will almost certainly push Europe into deeper recession, and could push the US from its current slow growth trajectory into recession. There is also the possibility of a disorderly EU breakup, which could include bank failures and result in unanticipated losses in the US financial system.

Apart from Europe, the US faces its own challenges with looming tax increases and government spending cuts which cumulatively represent several percent of GDP. These are to go into effect at the beginning of 2013 if Congress fails to pass a new budget, or deferral of the taxes and spending cuts, before then. In all likelihood a compromise will be reached on this issue before the country goes over what is now being called a fiscal cliff. But as was the case a year ago, the uncertainty preceding compromise may foster additional volatility in markets.

Finally, recent US economic data suggests that while the economy is still growing, the pace of that growth has slowed. Already several large US corporations, including Proctor and Gamble, have reported that their sales have flattened in recent months. On the bright side, falling gasoline prices should benefit consumers, and lower energy and raw material costs should benefit most corporations.

Portfolio Strategy

In response to signs of economic weakness I maintained and in some instances increased the defensive stance of your portfolio. Currently, roughly one third of your holdings are stocks while the balance is divided between cash, corporate bonds, preferred stocks, and real estate investment trusts. With our relatively conservative exposure to stocks we may not fully participate in up moves in the US stock market but our losses should be more contained if we experience a significant market correction.

I sold some of our more cyclical equity holdings. For example, I sold shares of Rush Enterprises, a dealer in commercial trucks. Sales of Rush Enterprises were not based solely on the cyclical nature of trucking; there had been several internal developments at Rush, including an aggressive 2011 executive pay package disclosed in April of 2012, which made me question the extent to which Rush management was focused on creating value for shareholders.

At the same time I invested not only in medium maturity corporate bonds but also in the stocks of companies with less cyclical businesses. For example, I added to holdings of drugstore chain CVS, which has recently benefited from a dispute between its largest competitor, Walgreens, and the drug insurer Express Scripts, leading some former Walgreens customers to shop at CVS. I also purchased shares in several multinational corporations which have had lackluster share price performances over the last decade despite good operating performances and positive outlooks. Microsoft is one example. Microsoft's shares trade at roughly the same price as a decade ago, despite a tripling of earnings during that period. The company's results have been relatively well insulated from recession, with earnings rising in the 2001 recession and falling only slightly in 2009 following the banking crisis. Microsoft also has a mobile phone initiative with Nokia which could be more beneficial to earnings than investors expect.

Notes on Specific Holdings.

I recently visited EDAC Technologies' manufacturing facility in Connecticut. EDAC makes discs and enclosures for the engines that power airplanes, helicopters, and power plants. I was again impressed by the company's expanding participation on sub-contracts for major aerospace manufacturers. Each of these sub-contracts will contribute to EDAC's earnings for at least several years. I continue to opportunistically add to this holding.

First quarter earnings for our large equity holdings, including MFC Industrial, Macquarie Infrastructure, EDAC Technologies, and Tronox Corp. were generally good, with the companies reporting good revenue and profit growth. Those results were overshadowed however by concerns that future results would weaken along with the global economy, leading to weak stock performance in May.

This was particularly the case for Tronox Corp, a manufacturer of TiO2. The health of Tronox's commodity oriented business depends in part on stable demand from China and Northern Europe, both of which look increasingly uncertain. I have in consequence reduced our holdings.

In general I have reduced accounts' exposures to natural resources such as oil and natural gas in response to what appears to be slowing demand and rising global supply. Our primary remaining bet in the natural resource area is agricultural fertilizers (mined potash and phosphates), an industry where current supply growth is limited and where demand has held up relatively well in prior recessions.

In addition, after selling most holdings of US Lime in the $50s and $60s last year, I have reestablished that position in the mid $40s, as the stock has fallen without any real change to earnings outlook. The company owns limestone quarries located near economically active parts of Texas. Limestone is a regional business given high shipping costs, and it is expensive and politically difficult to permit new quarries, limiting supply. This has allowed limestone miners to raise prices through recessions. Given the attractiveness of the business, US Lime could very well be acquired in coming years by a larger mining concern or by current management at a substantially higher price.

Another core holding, Old Republic International, stumbled this quarter despite good earnings. Old Republic had planned to spin off its troubled mortgage insurance line into an independent stock. However, under apparent pressure from government regulators, the spin-off was cancelled. After the change in strategy the stock sold off sharply, even though Old Republic's primary business, commercial insurance, was entirely unaffected. The stock now pays close to a nine percent dividend, well-covered by operating cash flow. Old Republic's veteran CEO continues to actively buy the company stock in the open market – always an encouraging sign. I have added to this holding on the current share weakness, which appears to me greatly overdone.

Income allocations (bonds, preferred stocks, REITs, and MLPs) continue to represent more than half of holdings. A recent addition was preferred stock issued by the largest mortgage REIT, Annaly Capital, yielding 7.6%. I view the security as relatively safe given Annaly's high quality asset portfolio, comprised almost entirely of US government backed mortgage bonds.

I have also increased portfolios' allocations to very low risk bonds and preferred stocks with yields ranging from 3% to 5%. While these yields are not especially exciting, the securities have very little credit risk and typically have three to five years to maturity, limiting their interest rate risk. As such, they will likely hold their value even in a very weak market.

Sincerely,

Douglas Weiss

Doug Weiss

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.