October 15, 2012

Dear Investor,

Accounts ended the September quarter near all-time highs, on average up more than 15% for the year to date. Accounts have participated in much of the upside of this year's strong US stock market. At the same time, investment risk has been less than the overall stock market, as a result of diversified holdings of stock, real estate investment trusts (REITs), preferred stock, bonds, and cash. Currently, roughly 40% of holdings are stocks while the balance is divided between cash, corporate bonds, preferred stocks, and real estate investment trusts.

It has been an unusually strong year for stocks, but also a good year for bonds and other income generating securities including preferred stocks and REITs. Investors seeking reliable income are increasingly willing to pay a premium for these securities. Our investments in this area have done particularly well, accounting for a substantial part of year to date gains.

As a group, bonds have risen more uniformly than stocks over the last two years. A number of stocks have not kept pace with the broad US stock indexes, even as their underlying businesses have improved. Some of these stocks now appear to be good investments, while the bonds of the same issuers look expensive. I provide an example of this development at the end of this letter (US Cellular Case Study).

I sold bond holdings which now appear fully valued and shifted the proceeds to stock as well as to more attractively valued bonds. Despite seeing opportunities in stocks, I continue to emphasize a large allocation to bonds and preferred stocks as a way of limiting overall account volatility. For the next quarter I plan on maintaining allocations to common stock at 40% to 45% of holdings (up from 35% earlier in the year) with the balance in cash, real estate investment trusts, bonds and preferred stocks.

Notes on Specific Holdings

A number of holdings, including Pepsi, Tronox, Air Products, and Cascade Corp., reported second quarter earnings that were flat with a year ago, as modest business growth in the Americas and Asia was offset by declines in Europe. This trend is likely to continue for the rest of this year. Even in this environment however, these companies are generating substantial free cash flow, and are investing in new projects which should support longer term earnings growth. These stocks are yielding 3% to 4.5%, and dividends should grow as earnings improve. These names continue to be worth holding for the combination of current yield and future growth.

Some of our holdings are posting strong earnings growth despite the slow economy. Macquarie Infrastructure, which owns and operates oil storage terminals, grew earnings 21% for the first six months of the year, reflecting the combination of higher storage rates and lower operating costs. The company lifted its dividend to $2.50 annually, representing an attractive 6% yield at the current stock price.

Google, a relatively new holding, posted 15% second quarter earnings growth, reflecting increasing usage of its internet advertising platforms.

MFC Industrial, a distributor of commodities and plastics, recently acquired an iron ore mine in Missouri and substantial natural gas reserves in Canada. Both acquisitions were purchased from financially strained sellers at deeply discounted prices. The assets add to MFC's growing portfolio of owned resources and should help support strong earnings growth over the next few years.

Outlook

The risks I've identified in prior notes persist. These include:

1) Slow global growth, with recession in much of Europe, slow growth in the US, and slowing growth in emerging markets, particularly China.
2) A 'fiscal cliff' in the US, which if left unaddressed would increase taxes and reduce government spending, stressing an already fragile economic recovery. A portion of the budgetary impacts will be mitigated through political compromise but it's not clear yet how much.
3) Political instability in the Middle East, with possible follow on effects on oil prices.
4) Solvency concerns for financially weak European countries, with large deficits exacerbated by shrinking economies and high borrowing costs. Europe's Central Bank (ECB) has mitigated short term liquidity pressures through bond purchases, but budget imbalances remain. EU sovereigns could still default on national debts, destabilizing global markets.

At the same time, there are positive developments in the American economy. Housing values and sales appear to be improving, with a host of positive follow on effects, including improved consumer sentiment and increased construction activity. Cheap US natural gas should support lower production costs for US industry, particularly chemical manufacturers. Durable goods, including passenger cars and industrial trucks are aging and in need of replacement.

On balance, the best guess is that the positives and negatives are offsetting, and that the US economy plods along at a low single digit growth rate. With that in mind, I continue to look for investments that can offer positive returns in an environment of slow economic growth, or that have exposure to improving industries, such as housing.

Sincerely,

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. YTD investment return calculation is based on the average return of all client accounts managed for at least one year and is reported net of a 1% management fee.

US Cellular Case Study: A Shifting Return Outlook for the Company's Stocks and Bonds

When I review companies as prospective investments I first establish the attractiveness of the underlying business. If the business satisfies certain criteria, including excess cash generation and relatively high barriers to entry, I then look at pricing across the company's capital structure, comparing the price of its stock with its bonds and preferred stocks.

Public companies rely on a mix of financing to fund their assets, and that creates a variety of securities available for investment. Consider a supermarket chain that needs to finance its investment in land, stores, inventory, and employees. It can fund some of those costs with cash earnings, but much of the financing will come from lenders and investors who buy stock in public offerings. Lenders then receive contractual payments while stock investors get what's left over. If the amount left over increases over time, the value of the stockholders' investment, reflected in the stock price, grows.

Lenders are first in line for payment resulting in lower risk of loss if the business has problems. Ordinarily that means that lenders expect lower total returns than stock investors. However, in 2009 and continuing into 2010, disruptions in the preferred stock and bond markets led in some cases to a reordering of expected returns. During this time many companies' bonds and preferred stocks offered similar or higher returns than their common stock, with less risk of loss. This presented a very attractive investment opportunity.

Here's an actual example. In July of 2009, ten months after the fall of Lehman Brothers and the ensuing financial crisis, US Cellular Corp's capital structure looked like this:

US Cellular Corp	Maturities	Amount ($ Mil)	7/1/2009 Price*	Credit Rating	Expected Annual Return	Risk of Loss Over 3 year Period
6.7% Senior Debt (Unsecured)	2033	544	88	BBB-	8.0%	Low
6.4% Senior Debt for retail (Unsecured)**	2033	13	65	BBB-	11.0%	Low
7.5% Senior Debt (Unsecured)	2034	330	89	BBB-	8.5%	Low
Common Stock***	NA	3100	36	Not Rated	9.0%	Moderate to High

* 100 is 'par', the amount to be repaid at maturity. The price of 88 means the security was trading 12% below the expected payment at maturity.
** This bond was a carve out of the 6.7% Senior Debt, resold to retail investors in smaller dollar denominations.
***Expected stock return is the most subjective of all the numbers above as it is based on estimates of the company's future earnings.

A few things are unusual in the July 2009 US Cellular's security pricing shown above. First the expected return on all the senior debt is close to the expected return on the common stock, despite less risk of loss. Further, the 6.4% Senior Debt, which was marketed to smaller retail investors, traded a wider than normal discount to nearly identical 6.7% senior bonds, and offered an expected return of 11% -- unusually high for an investment grade bond at a time when 20 year treasuries were paying about 4%.

Consistent with the higher expected returns, over the last three years US Cellular's actual bond performance has outperformed that of the company's common stock. The re-packaged retail bonds have performed particularly well, up 82% over the last three years:

	Price	Price	Cumulative Return*	Annualized Return
	7/1/2009	7/2/2012		
6.7% Senior Debt (Unsecured)	88	106	41%	12%
6.4% Senior Debt for retail (Unsecured)**	65	106	82%	22%
Common Stock	35.8	41.1	15%	5%

*Return is adjusted for dividends and interest received.
** This bond was a carve out of the 6.7% Senior Debt, resold to retail investors in smaller dollar denominations.

However with each year of outperformance for US Cellular's bonds since 2009, their expected returns have declined relative to the common stock. Having underperformed the bonds in each of the last three years, US Cellular's stock now offers a higher expected return. Note also that the risk of loss has increased somewhat for the bonds because today's lower yield leaves less room to offset any increase in market interest rates:

US Cellular Corp	Maturities	Amount ($ Mil)	9/1/2012 Price*	Credit Rating	Expected Annual Return	Risk of Loss Over 3 year Period
6.7% Senior Debt (Unsecured)	2033	544	104	BBB-	6.3%	Moderate
6.4% Senior Debt for retail (Unsecured)**	2033	13	104	BBB-	6.0%	Moderate
7.5% Senior Debt (Unsecured)	Redeemed by Company at par					
Common Stock***	NA	3260	38	Not Rated	12%**	Moderate to High

* 100 is 'par', the amount to be repaid at maturity. The price of 104 means the security was trading 4% above the expected payment at maturity.
** This bond was a carve out of the 6.7% Senior Debt, resold to retail investors in smaller dollar denominations.
***Expected stock return is the most subjective of all the numbers above as it is based on estimates of the company's future earnings.

So unlike in 2009 and 2010, when the bonds offered similar expected returns with less risk, now the common stock offers much higher expected returns. And while the stock is still riskier than the bonds, the risk disparity has narrowed. The stock has become a better buy relative to the debt, and an increasingly attractive investment proposition on an absolute basis.