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Registered Investment Advisor

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Dear Investor,

Your accounts finished the third quarter near their highest levels to date. Investor accounts continue to roughly keep pace with the very strong performance of the US stock market despite not being fully invested in stocks. That performance has come about partly as a result of substantial gains this year on a few smaller capitalization holdings, including Entravision, Rite Aid and Liberator Medical, as well as generally good performance for our large cap holdings, including CSX Corp, Bank of America, and Moody's.

<u>Some Comments on the economy and markets</u>

Janet Yellen, the current Fed Vice Chairman, now appears likely to succeed Ben Bernanke as Fed Chairman next year. Yellen is widely expected to maintain highly accommodative monetary policy, which thus far has been supportive of high stock prices. Markets do expect a curtailment of the Fed's bond purchasing program over the next two quarters, but if Yellen is appointed the curtailment may be more gradual.

As of this writing the Federal Government has missed the deadline for passing a budget and has shut-down non-essential government agencies and services which require annual budgetary appropriations. Of more concern to markets, the US debt ceiling needs to be increased by mid-October, and we appear to be in for more of the brinksmanship which destabilized markets in late 2011. These self-inflicted crises seem to occur with increasing regularity, although since late 2011 their impact on stocks has been muted. I have increased cash levels modestly, so that we can purchase good stocks should prices fall in response to political developments. At the same time, I have not changed current holdings dramatically, because an eventual political compromise appears nearly inevitable.

From an investing standpoint, bonds still look fully valued, and stocks look only slightly better, following two years of substantial gains. That said, I am still finding individual stocks which appear reasonably priced and which I believe will provide acceptable returns over the next several years.

<u>Notes on Portfolio Allocations and Specific Holdings</u>

Your portfolio contains both large and small companies. Generally speaking, it is more difficult to find 'bargains' among the large companies in which we invest, as these tend to be closely followed by well informed investors. From time to time however I identify large, global companies trading at discounts to a reasonable estimate of their fair value. Usually this occurs because investors are concerned about operational issues or the company's financial health or both. If I have good reason to believe such concerns are exaggerated, I will purchase these stocks with the expectation of returns above those of the broader stock market.

One large company which I believe is undervalued today is General Motors (GM). GM continues to trade at a discount to other automobile manufacturers in large part due to its 2008 bankruptcy filing and subsequent partial ownership by the US government. The government recently sold a substantial portion of that ownership into the public markets, and is likely to sell the remainder over the next year.

GM's financial position today is much stronger than it has been for decades. This is due to a combination of debt restructuring in bankruptcy, and very strong profitability subsequent to bankruptcy. As of last quarter, GM had $25 billion of net cash (ie, cash in excess of debt) on hand. GM's cash position is now sufficient to insure that it will be able to service its remaining pension and health care obligations, while still financing future growth investments and returns of capital to shareholders.

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GM's earnings outlook is also positive. The average age of cars in use is several years past historical averages, suggesting that recent improvements in new car sales are likely to continue. And many new car buyers are likely to buy cars made by GM. The company has significantly upgraded Cadillac, which sells in the higher margin luxury market, and has made substantial improvements to its GMC truck line, which already has dominant market share. These improvements are evidenced by improving quality reviews by JD Powers, Edmonds, and Consumer Reports for a range of GM brands, including Cadillac and GMC. GM also has significant opportunities to cut costs by consolidating its manufacturing onto fewer parts and equipment platforms.

Turning to smaller companies, a recent addition to our holdings is First United Corporation, a small community bank operating in Maryland and West Virginia. First United was hard hit by the recession, as the bank incurred a number of loan losses, particularly on loans related to commercial real estate. Over the last three years the bank has steadily written off and restructured bad loans, issued equity to improve financial strength, and grown earnings, largely by writing better quality loans. Today, the bank is well capitalized and solidly profitable. Despite these improvements, First United still trades at a low multiple of current earnings and a deep discount to the value of its net assets – valuation levels that do not properly reflect the bank's improving fortunes. I expect the bank's profits and valuation to improve in the years ahead, as it begins to earn somewhat higher rates on new mortgage loans. Longer term, the bank is a very plausible acquisition target for larger banks in its markets.

As always, let me know if you have questions or comments.

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.