April 8, 2014

Dear Investor,

Client accounts finished the first quarter up by roughly 3%, slightly ahead of the S&P 500. That relatively good performance reflects a strong first quarter for a few stocks, notably Motorcar Parts of America, as well as a good start to the year for our income holdings.

Aside from those investments, it has been a slow start to the year, both for our holdings and for the broader stock market. While I still think a carefully selected stock portfolio offers the best chance for long term gains, I'm less optimistic about the near term outlook, for a few reasons:

1) Stock prices have risen relative to earnings, and are now towards the higher end of historical averages.
2) Earnings growth in recent years has been driven in large part by slowing the growth of costs amid rising sales. This has been achieved partly through headcount reductions or reduced hiring, even while production has grown. It's not clear that this trend can continue much longer.
3) Broader economic growth appears likely to remain sluggish, as improvements in the US economy continue to be offset by slower growth in Europe and emerging markets.

In response, I have increased your portfolio allocation, on the margin, towards less volatile bonds and preferred stocks. Some of these securities yield around 8%, with a low likelihood of default. In the current low rate environment that combination strikes me as attractive. Those yields are likely high enough relative to treasuries that the securities I've purchased won't be badly impacted by modest increases in interest rates.

As of quarter end, roughly one third of client holdings are invested in bonds, preferred stocks, and real estate investment trusts. The balance is allocated to traditional stocks.

Notes on Specific Holdings

Quality Distribution: I continued to add to holdings of Quality Distribution. Quality's primary business is trucking chemicals from US chemical manufacturers to distributors and end users. The company transported 13% of all bulk chemicals moved by truck in the US last year, and is the largest US tank trucking provider. Quality is well positioned to benefit from the growth of US based chemical production, as producers locate more plants domestically to take advantage of low natural gas prices. I believe this trend will continue over the next several years, supporting Quality's expansion. The company should also benefit as it continues to use its free cash flow to reduce high-cost debt, thereby reducing interest payments. Finally, given a fragmented US tank trucking market, Quality should have opportunities from time to time to acquire competitors at good prices, increasing both sales and earnings in the process.

Delta: I began purchasing Delta last year for accounts, and continue to like the company and stock. For many years, the airlines were un-investable, given high levels of debt, powerful unions, highly volatile fuel costs, and intense competition. Often, after a good year, airlines would invest aggressively in new planes. This in turn led to fierce price competition as carriers tried to fill those expensive planes. Add in periodic spikes in oil prices and high labor costs, and all of the major airlines, with the exception of Southwest, ended up at one time or another in bankruptcy restructurings.

The situation for the major airlines has improved substantially over the last few years. The number of major carriers has been cut in half, as Delta merged with Northwest (2008), United merged with Continental (2010), and American Airlines merged with US Airways (2013). That has left the industry with three major carriers -- Delta, United Continental, and American -- a super-regional – Southwest -- and a handful of smaller regional providers. Fewer airlines means fewer planes, fewer seats, and higher ticket prices. If you've flown over the last two years on a major airline you've probably noticed the change. It's rare to find a ticket these days much below $400, even before including extra charges for bags and on-flight meals. And more often than not planes are full.

Having gone through so many past difficulties due to overcapacity, the carriers have become more disciplined in their purchasing and use of planes. As long as that remains the case, ticket prices should remain high. Adding to my confidence in this regard, several of the highest traffic airports in major cities have little or no capacity for additional planes. This should further discourage the rapid expansion of plane fleets, particularly as flights arriving and departing from the highest traffic airports account for a disproportionately large percentage of airlines' profits. Tight airport capacity is likely also to discourage any potential new entrant to the business.

At the same time that the airlines' revenue predictability has improved, their costs are more controlled. Fuel efficiency has significantly improved as a result of better engineering on new planes, and a domestic oil boom is providing a reliable source of reasonably priced fuel. Employee compensation and benefits have become more realistically aligned with long term earnings.

These trends are favorable for all the public airlines. I have focused on Delta because in recent years it has had the best record of profitability, has made significant operational improvements, and continues to realize substantial cost savings from its merger with Northwest. In addition, Delta's stock trades at a modest discount to other airlines and a wide discount to the broader stock market.

I remain alert to the possibility of the airlines returning to the self-destructive expansion patterns of the past, but for now I think the outlook for Delta looks promising.

As always, let me know if you have questions.

Doug