CASTLE INVESTMENT MANAGEMENT

Portfolio Manager Commentary

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CASTLE FOCUS FUND

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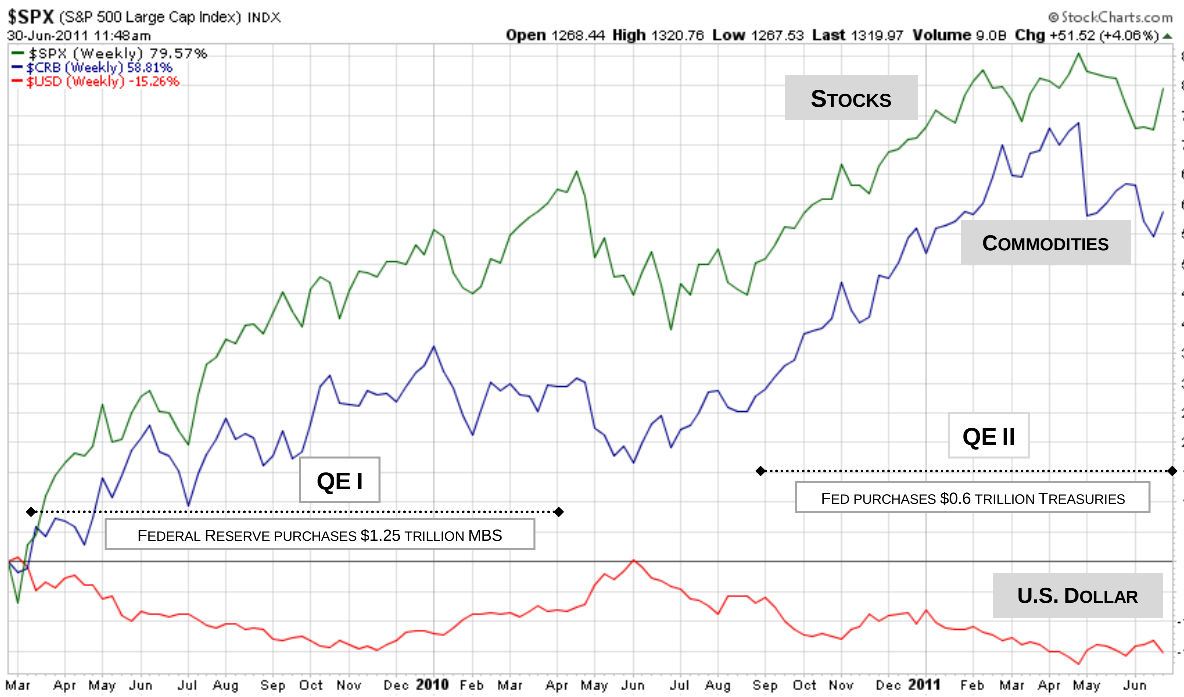
SECOND QUARTER LETTER

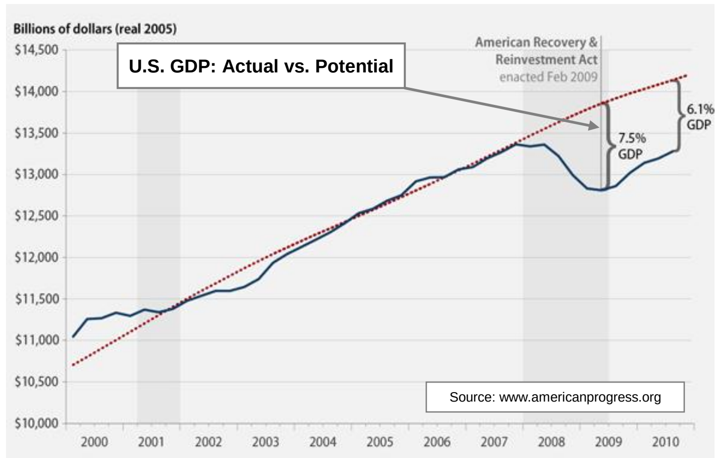
MARKET COMMENTS

Just as children experience a sugar rush after eating sweets, the investment markets just demonstrated their version of a sugar high as well. Assets ranging from commodities to stocks jumped while the U.S. dollar was pummeled by one of the largest experiments in recent central bank history: the second round of quantitative easing (QE) by the Federal Reserve. The Federal Reserve had been buying about $6 billion in U.S. Treasuries per week. That buying is now over. Former Federal Reserve Chairman William McChesney Martin once described the Fed's job as taking away the punchbowl just when the party gets going. The punchbowl has now been removed.



Asset price inflation is certainly a consequence of quantitative easing. From its low point in March 2009, the S&P 500 rebounded by 80%. Commodity prices, as measured by the Reuters Jefferies CRB Index, jumped by 60% over the same period, while the U.S. dollar fell by 15%. Although QE was designed to help the economy, some would argue that it could eventually end up doing more harm than good with higher energy and food prices squeezing an already weak consumer. In fact, the end of June marked two economic milestones. The Federal Reserve's quantitative easing in the form of easy monetary policy came to a close, and the economic recovery that QE was designed to spur reached its second anniversary. We doubt many will be celebrating this anniversary. Since the recession ended in June 2009, gross domestic product (GDP) has averaged 2.8%, roughly its long-term trend. Yet typically after such a deep slump, the economic rebound is far more robust.

The chart below highlights the hole left in the economy since the start of the "Great Recession" in December 2007. As illustrated, U.S. economic activity, or GDP, has fallen well below potential if workers and the economy's productive assets were used at full employment. As a result, the gap between actual and potential GDP is currently stuck around 5%. From some angles, the picture is even worse. If we measured the economy by income rather than by spending, the U.S. economy would be no larger than it was in 2006. Given the amount of monetary and fiscal stimulus applied to the economy, the recovery has been a disappointment – but why?



According to Stephen Roach, former Morgan Stanley analyst and author of *The Next Asia*, the economy is being hobbled by a generation of "zombie" consumers, otherwise known as the "economic walking dead". Roach states, and we agree, that the U.S. consumer is in the early stages of an unprecedented retrenchment. In the 13 quarters since the beginning of 2008, the growth in consumption has never been weaker than in any post-WWII period. Prior to 2008, the U.S. consumer binged for 12 years on easy credit and rising real estate prices. It will take a long time for consumers to recover from debt-induced excess spending. Unfortunately, fiscal and monetary policymakers in Washington are doing everything they can to delay this long overdue consumer retrenchment. However, we believe consumers are more intelligent than policymakers. Consumers know that Washington's policies are unsustainable and that any assistance will be temporary. Less spending, less debt and more savings are the only true long-term options for consumers.

Going forward, how markets react will demonstrate whether or not the Federal Reserve's experiment with quantitative easing was ultimately successful. With unemployment remaining high and economic growth stubbornly low, we question whether the Federal Reserve's initiative had any real lasting economic impact. Maybe this unprecedented stimulus simply encouraged more speculation in tradable assets. Our concern is that risky assets, such as equities, will not fare quite so well once the Federal Reserve stops expanding its balance sheet. Even the casual observer now understands that a positive correlation exists between the Federal Reserve's increase in liquidity and the market's appetite for risk.

And yet the eternally optimistic on Wall Street continuously cite soaring corporate profit margins and anticipated earnings as reasons to remain bullish and fully invested in stocks, with a particular emphasis on the more cyclically-sensitive companies. Wall Street analysts, as is often the case, remain prone to projecting the recent past deep into the future. These analysts argue that high profit margins can be sustained indefinitely. Wall Street believes that after the most recent severe downturn, companies have slashed their costs and will not be dumb enough to let these costs return. Extending their logic, Wall Street assumes that it is in the nature of companies to get bigger, faster and stronger; therefore, why not more profitable?

Unfortunately, this path of reasoning contradicts reality. Corporate profit margins revert to the mean because we hopefully still operate in a free market. As the economy grows, companies generate larger profits. Competition reacts to those larger profits, which is the very essence of free markets. As competition increases, above-average margins revert to the mean. Perhaps Jeremy Grantham of GMO stated it best when he wrote: *"Profit margins are probably the most mean-reverting series in finance, and if profit* *margins do not mean-revert, then something has gone badly wrong with capitalism. If high profits do not attract competition, there is something wrong with the system and it is not functioning properly."*

Frank Zappa, the musician, once said that rock journalism is for people who can't write, interviewing people who can't talk, for people who can't read. Maybe something similar can be said for stock markets. They are short sighted, unpredictable, often mispriced and typically followed by equally confused investors. Usually a severe shock to the financial system dampens the appetite for risk for some period of time afterwards. The economy needs time to recover, as banks recapitalize, bad debts are written off, and the consumer retrenches. Although excessive leverage and overpriced assets contributed to the most recent credit crisis in 2008, the core ingredient of any financial crisis is boundless optimism. We are not even three years past the collapse of Lehman Brothers, yet Wall Street finds little reason for caution. CNN Money asked 26 financial experts their year-end targets for 2011. Those polled included some of the largest firms in the world – Goldman Sachs, Cantor Fitzgerald, Morgan Keegan, Wells Fargo, and etcetera. Not a single investment professional thought the S&P 500 would be lower at the end of the year than it is today. Everyone is bullish.

As contrarians by nature, we are always leery of the bullish consensus. With the many potential pitfalls in today's market – a slowing Chinese economy or an insolvent Europe, to name only two, one has to marvel at how 26 out of 26 investment professionals are bullish. "Often wrong, but never in doubt" seems applicable to the Wall Street consensus. As investors, we continue to proceed with caution.

INVESTMENT PHILOSOPHY

An old issue of *The Journal of Portfolio Management* (Fall 1984) contained an article about the founder of a prominent trust company who told the story of a couple he worked with as an investment counselor for about a decade through the mid-1950s. Since wealth preservation was the primary objective of the client, the investment counselor followed his firm's guidelines to make sure the client's portfolio was sensible and well-positioned. The counselor worked primarily with the husband on a portfolio in the wife's name. Years later, after the husband died, the wife called to say that she had inherited his estate and was adding his investment positions to her portfolio. As the investment counselor reviewed the combined portfolio, he discovered that the husband piggybacked on the trust company's buy recommendations for his wife's portfolio. The husband purchased $5,000 of each stock; put the certificate into a safe deposit box and simply ignored the investments—not unlike putting money in a shoebox and sticking it in the closet.

The investment counselor was shocked when he compared the results—the value of the husband's "buy-and-hold" portfolio greatly exceeded that of his wife's portfolio. In the husband's portfolio, a number of holdings had declined to $2,000, several large positions exceeded $100,000, and one stock had a value in excess of $800,000. The husband, who simply purchased undervalued stocks and did nothing, handily outperformed the trust company's actively managed portfolio. Warren Buffett best summarized this strategy when he said, "*Lethargy bordering on sloth remains the cornerstone of our investment style*." Most of us are taught from a young age that effort leads to results. However, if you take effort to mean trading activity, the lesson from this story does not apply to long-term investors. The message here is simple: investors often make changes to their portfolios that do not add value. This is just as true for sophisticated institutions as it is for the unsophisticated individual. The moral of the story is that doing less can you leave you with more.

Self-control is the key to much in life and, when investing, it is the key to almost everything. Even the most intelligent go wrong when they invest because they cannot control their emotions. Barclays Wealth Management just published a survey of 2,000 very wealthy people, all of whom had significant portfolios of investable assets. The survey asked each participant about their self-control and the strategies they used to overcome personal indiscipline. Although we are not sure how scientific any such survey can be, as it relied more on qualitative responses rather than quantitative data, the results were still interesting. It appears that the wealthy are as fixated on trading as everyone else. Barclays found that 1/3 of its wealthy respondents thought that "to do well in the financial markets you have to buy and sell often" while 40% described themselves as trying to time the market rather than use a "buy and hold" strategy. Despite this self admission by the participants, 16% of them still said that they traded too much! Clearly trading appears to be disconcertingly addictive: investors do it too much and cannot stop themselves. In our opinion, a critically important investment axiom is that the market is difficult if not impossible to time and the more one trades, the less likely one is to make money. The only certainty is that the financial services industry will continue to benefit as investors generate more revenue in the form of transaction fees and brokerage commissions.

We highly regard the thoughts of Howard Marks, Chairman of Oaktree Capital, who often credits a 1975 article in *The Financial Analysts Journal* (July/August 1975) as an important contributor to his investment thinking. In the article, titled <u>The Loser's Game</u>, Charles Ellis argued that increasing competition among highly skilled professional investors had turned investing from a "Winner's Game", in which aggressive, deliberate actions of a privileged few could generate consistent outsized returns, to a "Loser's Game", where the emphasis must shift toward making fewer mistakes than others. In particular, institutional dominance transformed the money game from a Winner's Game to Loser's Game. More and more institutions entered the money game in search of outsized returns *(free markets invite competition and profit margins revert to the mean)*. Ironically, the reason institutional investing has become a Loser's Game is that each manager is trying to optimize their position in solving a complex problem (outperforming the market). The collective efforts of more and more institutions trying to optimize their position have changed the game. Ellis concludes his article with the following statement, "Their efforts to beat the market are no longer the most important part of the solution; they are now the most important part of the problem."

So how does one win the Loser's Game? Sometimes an investor can learn more by looking outside their chosen area of expertise. Admiral Morrison, a military historian, published his study of the Pacific theater during World War II, *Strategy and Compromise*, in 1958. Admiral Morrison made the following point: "In warfare, mistakes are inevitable. Military decisions are based on estimates of enemy strengths and intentions that are usually faulty, and on intelligence that is never complete and is often misleading." Most investors can readily see the analogies between investing in the markets and Admiral Morrison's military observations. Morrison concludes, "Other things being equal, <u>the side that makes the fewest strategic errors wins the war</u>." In other words, those who want to win the Loser's Game must know their strengths and discipline and play according to them at all times. An investor must deliberately dictate their actions and never react to the players in the market. Perhaps better said by Admiral Morrison: "Impose upon the enemy the time and place and condition for fighting preferred by oneself."

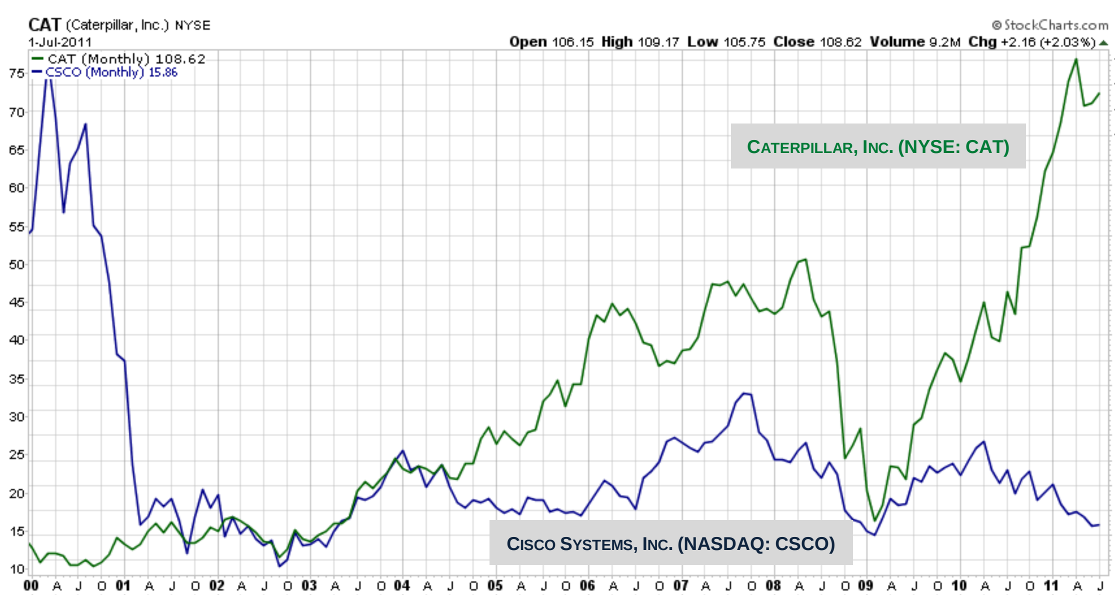
When investing, our view of the markets is informed primarily from the bottom up. We are continuously shifting through the business models and reported financials of companies in the never ending search for value by looking at the same issues again and again. When we purchase a stock for a portfolio, we are extremely conscious that our actions commit the hard-earned money of our families and clients to the volatility of the publicly-traded markets. Therefore, in order to make the fewest mistakes in a Loser's

Game, we adhere strictly to our time and place and condition when choosing to invest. In the simplest investment terms, we want to purchase a good business at a good price and then patiently monitor the company's ability to compound our investment. Our investment decisions should always reflect judgments about the long-term prospects of specific companies rather than opinions about short-term market prospects. Or as Warren Buffett said, active trading "is like calling someone who repeatedly engages in one-night stands a romantic."

Every fundamental investor has their own definition for a good business. From observation, we see that today's most profitable businesses are those which sell a service or product at a very low marginal cost. Good businesses are generally considered those with strong barriers to entry, require limited investment capital, serve reliable customers, carry minimal risk of technological obsolescence, see abundant growth possibilities, and have the ability to sustain and grow free cash flow. While there are many companies that can demonstrate one or several of these attributes, there are very few companies that exhibit all attributes. And as if finding a good business were not demanding enough, we also want to pay a low price in relation to the business' value. This discount to our estimate of fair value is our margin of safety.

We will always make mistakes or use incorrect assumptions when valuing a business; therefore, we want the protection that a discounted entry price provides. When an investor forecasts future revenue, profit margins, and cash flows to arrive at a fair value estimate, it can be easy to either miss or underestimate the impact of competition or macroeconomic headwinds. By choice, we prefer companies that exhibit less sensitivity to the economy or demands for large capital investments. In doing so, our estimate of intrinsic value could be off by 20% in either direction, but it would be hard to imagine being off by 50%. Holding a fairly valued stock, at least in theory, should mean earning a fair total return as a long-term investment. There is a great difference between purchasing a good business with an established margin of safety versus buying a good company at a fair or full price.

Consider two respected U.S. companies with good businesses – Caterpillar and Cisco Systems. To be clear, we own neither and have no dog in this fight. We just find the inverse symmetry in the chart below interesting. While Cisco Systems currently trades at 1/5th its previous high, Caterpillar trades at a price more than 5x its low.



Caterpillar, the manufacturer of earth moving equipment, trades at a premium valuation relative to the S&P 500 that we have not observed in 38 years – as far back as our data set reaches. Cisco Systems, the IT hardware networking company, now trades at a fraction of its dot.com, all-time peak valuation in early 2000. Still, over the past decade Cisco handily beat Caterpillar in both sales growth and earnings growth while simultaneously generating larger operating and profit margins. So why was there such a gross difference in performance over the last ten years despite one company outperforming the other in fundamentals? As with any investment, entry price is a critically important determinant to long-term investment returns because entry price determines *starting valuations*. In 2000, Cisco Systems traded at an average price-to-earnings (P/E) multiple in excess of 100, or an earnings yield of less than 1%. By contrast, Caterpillar traded at an average P/E multiple of 12.8 or an earnings yield of 7.8%.

At the height of the dot.com boom era, technology companies like Cisco Systems were grossly overvalued while traditional manufacturing companies like Caterpillar were despised. But there is a broader story at work, just as in the dot.com era. In today's market the fervor is all about the growth in developing nations, particularly China, which has a monstrous appetite for commodities, primary goods and heavy equipment. Caterpillar has been a clear beneficiary to this unfolding story with its highly cyclical business model. The company's sales growth over the past decade has averaged 3% within the United States and 11% in the rest of the world. As a result, 68% of Caterpillar's revenue now comes from international sales. If Wall Street's current investment themes fixate on the old world giving way to the new and emerging world, Caterpillar is at the front of that investment parade. Given the euphoria, we believe caution is necessary. Caterpillar has operated in the developing world for some time, including since 1960 in Brazil. Despite China's boom over the past decade, global growth has trended sideways. And while Caterpillar's current valuation does not come close to challenging the excesses of Cisco's valuation during the technology boom, the company's valuation is still expensive by any historic metric.

Those of us who remember the technology dot.com era realize that the broader investment story was correct – information technology and the flow of data proved to be the wave of the future. But the reaction to this investment fixation was overdone. In other words, any story spun by Wall Street eventually gets overbought. A good business bought at the wrong price can be just as painful as buying a weak business with a bad business model. At the moment, we find ourselves in an environment in which good businesses with attractive prices are difficult to find. And yet, in times like this, many investors find themselves trading simply to combat boredom. In contrast, we will not compromise our investment principles. Boredom leads to impatience, which leads to mistakes.

If you believe as one wise investor once said, that "*investing is like batting in baseball except that you get as many pitches as you want and you never have to swing. Wait for the 'home run ball' before investing*," then you understand that there is nothing wrong with being lethargic and patiently waiting for the right opportunity. We remain vigilant in our search for undervalued stocks of good companies. When the time comes to swing, you can confidently assume that we will respond accordingly.