Castle Investment Management

Portfolio Manager Commentary

St. James Investment Company
Sub-Advisor to the Fund

Castle Focus Fund

MOATX ***CASTX***

October 12, 2011

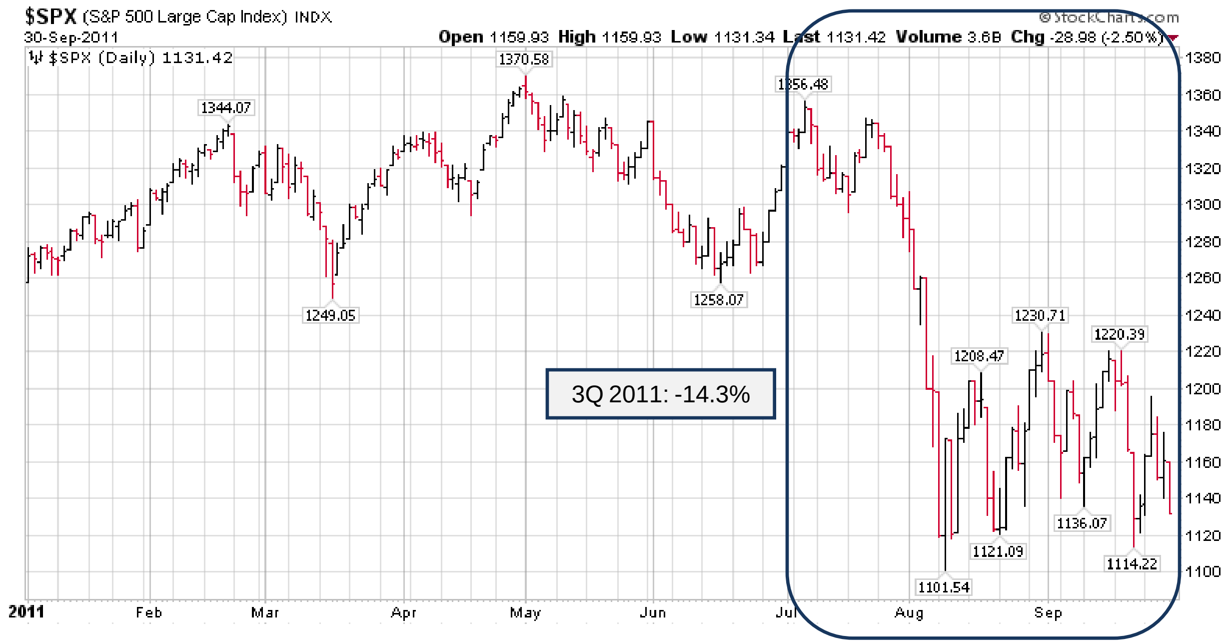
WWW.CASTLEIM.COM

703.260.1921

THIRD QUARTER LETTER

MARKET COMMENTS

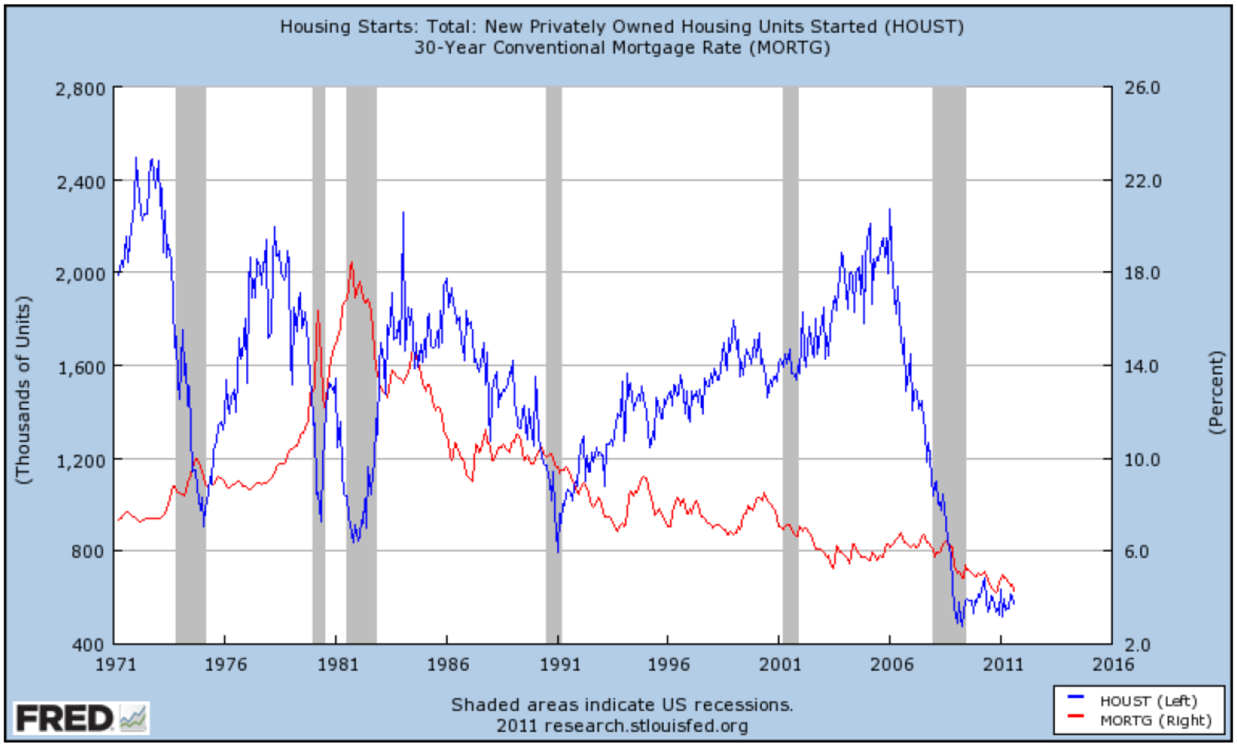
Stocks recorded their worst quarterly decline since the financial crisis in 2008, with the S&P 500 down almost 20% from its April high. The S&P 500 dropped 7.2% in September and declined 14.3% over the third quarter, its worst performance since the final three months of 2008, when the market dropped 22.6%.



On September 21st the Federal Reserve disappointed equity markets by announcing "Operation Twist", where the Federal Reserve targets purchases of 10-year Treasuries funded through sales of shorter term maturity holdings. Through this action, the Fed is hoping to drive mortgage rates to new and historic lows in order to spur mortgage refinancing and home buying. Because the housing market continues to underperform and act as a drag on the overall economy, the Federal Reserve wants to explore any possibility to buoy home prices.

The problem with "Operation Twist" is it could fail even if it works. Because mortgage rates are already so low, why would lowering rates solve anything? The problem is not that rates are too high, but rather that individuals cannot take advantage of the low rates that are already in the market. Most people want to refinance but cannot--they owe more on their home than the acceptable appraised value.

Perhaps "Operation Twist" reduces the yield on the 10-year Note and maybe even causes mortgage rates to decline. But would that marginal downward movement in rates really help the housing market or the economy? Will "Operation Twist" stop the wave of foreclosures? Mortgage rates are already at 50 year lows and we see no great rush to either buy or refinance.



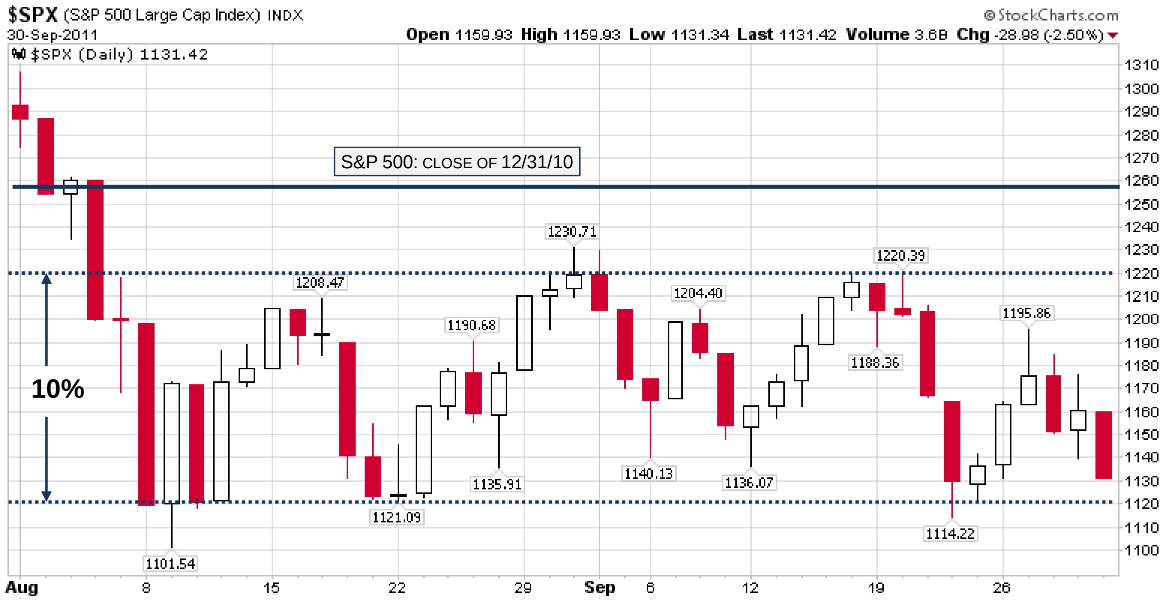
If the economy continues to deteriorate over the next several months, Federal Reserve Chairman Ben Bernanke may feel compelled to launch a third program of quantitative easing (bond purchases financed by the creation of credit). Our cynical retort would quickly be that even if the Federal Reserve commits another trillion dollars to QE3, what difference will it make? Our country's economy needs a sustained boost to demand – a condition beyond the capabilities of our central bank.

The Federal Reserve wants quantitative easing to bring down long-term interest rates that are not under their direct control, yet these rates are already at historic lows. In August, yields on 10-year Treasury Notes touched 1.7% and the yield on 30-year Treasuries fell below 2.7%. Even if QE3 brought long maturity rates down further, the impact would be modest at best. Money keeps getting cheaper but, rather than borrowing and spending, many businesses and individuals continue to increase their savings. When consumers and businesses are nervous, they postpone their investment and capital allocation decisions.

This looks like a modern version of the "liquidity trap" that John Maynard Keynes identified during the Great Depression of the 1930's in his book *The General Theory of Employment, Interest and Money*. When people are too scared to invest and spend, cutting interest rates does not accomplish much. Other means are needed to bump the economy. The usual choice is fiscal stimulus, which today appears politically out of the question. Although the Federal Reserve wants to communicate they have options to stimulate the economy, the real message is their concern about the weakness of the economy.

In our opinion, lower interest rates do not signify anything positive about the economy, consumer end demand, or future corporate profit margins. The consensus forecast for average growth in S&P 500 earnings for the third quarter has dropped to 13.1% from 16.5%, with the financial sector leading the pull back. However, Wall Street still sees full-year earnings at a record $97.53 per share, according to FactSet Research. We remain cynical about Wall Street's exceptionally high earnings forecasts and question the absolute (as opposed to relative) cheapness of stocks. As we believe that the US economy is likely already in a recession, Wall Street's earnings forecasts suggest that the longer-term outlook for most investors remain too optimistic. We would not be surprised to see Wall Street's expectations lowered over the next several months, perhaps leading to additional downward pressure on the markets.

We note that the S&P 500 is negative year-to-date (blue line below) and that it is currently bouncing between the 1120 and 1220 marks (dotted lines) with plenty of volatility but not much direction. Our simplest explanation for this price action is that tensions exist between what the deteriorating fundamental data says about the economy versus Wall Street's eternal hope that more central bank money will soon enter the market and push asset prices higher.



"What breaks us out of this range on the S&P is when investors decide whether the US is either entering a recession or is not," states Jim Paulsen, chief investment strategist at Wells Capital Management, a money management firm with $375 billion under management. This increasingly cautious Jim Paulsen stands in contrast to the same Jim Paulsen who said earlier in the year:

July 31: *"The great bulk of the evidence says there's definitely been a recovery going on in housing and today certainly adds to that."*

March 17: *"There's nothing here to stop the stock rally."*

December 4: *"We're within 5 to 6 points on the S&P of brand-new recovery cycle highs. If it does break through, there is a lot of room to the upside."*

We contrast Mr. Paulsen's remarks with Benjamin Graham's typical response whenever asked his opinion on the economy's direction or to estimate the market's earnings – "the future is uncertain." Graham was uncomfortable making forecasts and his goal was to always invest at a significant discount to current net asset value (current liquid assets minus ALL liabilities).

Graham wanted that margin of safety because of the simple fact that the future is indeed uncertain. Or as Yogi Berra said, "It's tough to make predictions, especially about the future." And yet despite Yogi's advice, investors who show no aptitude for making predictions continue to constantly generate new forecasts. Making predictions when the future is uncertain becomes even more difficult with the extraordinary surge of stock market volatility during the last several months. Clearly some of this volatility may be linked to news events such as the last-minute budget deal in Congress or the downgrade of our country's long-term debt, but most investors are still left wondering why there is so much market volatility.

John Maynard Keynes provided an answer by comparing the stock market to a beauty contest. To illustrate, Keynes described a newspaper contest in which 100 photographs of faces were displayed and readers were asked to choose the six prettiest faces. The winner would be the reader whose list of six came closest to the most popular of the combined lists of all readers. Keynes noted that the best strategy was to NOT pick the faces that you favored but rather select those faces that you thought others would think prettiest. Better yet, thought Keynes, move to the "third degree" and pick the faces you think that others think that still others think are prettiest. Similarly, in speculative markets, you win not by picking the soundest investment, but by picking the investment that others, who are playing the same game, will soon bid higher.

As noted by Yale economist Robert Shiller, we see such dismay among stock market investors today. Market participants are trying to guess whether other investors are thinking that yet others are thinking that the stock market is "dangerous," or whether it is instead a great time to invest. When we hear a conversation among "professional investors" on television, it often sounds as if they are engaged in just this kind of guesswork. We wonder just how many people are actually basing their decisions on rationale investment principles taught by Benjamin Graham: calculate fair value and apply a margin of safety to determine an asset's purchase price. Shiller believes that the best explanation for the market's back-and-forth swings is that each day the market is conducting a Keynesian beauty contest, and reassessing what others think that still others are thinking. On days without much news, the market is simply reacting to itself. And because fear is running high, investors make quick, impulsive decisions in response to relatively minor events.

INVESTMENT PHILOSOPHY

Decades ago, in what's now come to be known as the "Marshmallow Experiment," Stanford researcher Walter Mischel gave a group of three to five year-olds a choice: Eat one marshmallow now, or wait fifteen minutes and get two marshmallows. The experiment was intended to measure children's ability to delay gratification. Mischel discovered that about 30% of the children were able to wait fifteen minutes to get the second marshmallow; the rest gobbled it down before the time was up. There is a YouTube video that shows toddlers grappling with this weighty dilemma and it is both funny and instructional. The successful kids were able to distract themselves from the tempting marshmallow by singing to themselves, or covering their eyes, or playing hide-and-go-seek under the desk; they found some trick to delay eating the marshmallow. In short, they were sufficiently motivated to do whatever it took to get that second marshmallow.

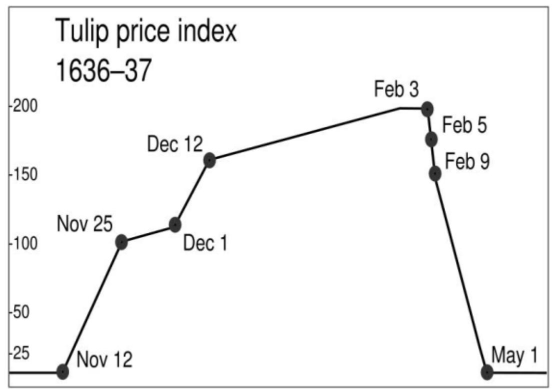
Throughout financial history there have been many financial booms and busts. The majority of investors are always short-term thinking, rushing to the boom - they cannot wait for the second marshmallow.

Nearly 400 years ago, there was a bubble relating to the tulip bulb (now referred to as the *Tulip Mania)*. In the mid-16th century, the tulip was just being introduced into Europe from the Ottoman Empire, the

Turkish Empire which lasted from 1299 to 1923. The tulip flower quickly became a luxury item and a status symbol. As the tulip grew in popularity, the tulip growers, as well as the wealthy, agreed to pay higher and higher prices for bulbs. In 1634, speculators began to enter the market. Ordinary bulbs were selling for extraordinary prices, and the very rare bulbs sold for ridiculously high prices. At the time, a Viceroy bulb could be exchanged for a package that included: a bed, a complete suit of clothes, a thousand pounds of cheese, two lasts of wheat, four fat oxen, eight fat swine, twelve fat sheep, two tons of butter, and four kegs of beer.

Charles Mackay, in his book, "*Memoirs of Extraordinary Popular Delusions and the Madness of Crowds*," published in 1841, wrote about the frenzy: *"Nobles, citizens, farmers, mechanics, seamen, footmen, maidservants, even chimney-sweeps and old clothes women, dabbled in tulips. People of all grades converted their property into cash, and invested it in flowers. Houses and lands were offered for sale at ruinously low prices, or assigned in payment of bargains made at the tulip-mart."*

In the time of 1636 – 1637, tulip traders and speculators were making extraordinary amounts of money--it was said that they could earn up to 60,000 florins in a month, or more than $60,000 in current U.S. dollars. The price of tulips increased by 20-fold within a single month. In 1636, the Dutch created a formal futures market where traders could transact in tulip bulbs at the end of the season and those contracts were bought and sold--buyers paid 3.5% of the contract price. At that time, no party had to post initial margin or mark-to-market maintenance margins. However, no contract was ever delivered because the bubble burst in the beginning of 1637.



Humans will always be driven by greed and envy, as it is part of our nature. The tulip lesson dates back nearly four centuries but still reinforce the timeless attributes necessary for long term investors: discipline and patience.

Stocks move up, down, and sideways and can remain cheap for long periods of time. We believe multiple years of cheap stock prices are a distinct possibility over the next five or so years. In very simplistic terms, bull markets go up while bear markets go down. Most people think those are the only two actions you experience in the stock market. Not so--if one looks at the stock market's performance over the last century, one sees bull markets punctuated by sideways markets, where stock prices bounce up and down, sometimes violently, for many years. To date, we have essentially been in a sideways market since March 2000, when the technology bubble popped.

To understand sideways markets one needs to understand valuations. Bull markets end and sideways markets begin when stocks are expensive. Sideways markets end and bull markets resume when stocks are cheap. And in between, stocks can remain extremely cheap. In the sideways market of 1966-1982, there was a period from 1977-1981 when stock prices averaged just over 8x earnings. That was a wonderful time to accumulate large holdings of high quality stocks. But it was a difficult time for those who believe the only way to make money is to speculate on higher stock prices—the adult version of the kids who couldn't wait fifteen minutes for the second marshmallow. Higher valuations due to a rising stock market are only one of three ways to make money in stocks. The other two means include earnings growth and dividends. Because higher valuations appear unlikely over the next several years, an investor should only invest in stocks of companies that can grow earnings and dividends. Therefore, when selecting companies we continue to emphasize the following attributes:

- *A good business*. The single most important indicator of a good business is its return on invested capital (ROIC). A company that generates superior returns on its capital over long periods of time demonstrates a unique position in its industry and/or has outstanding management. The ability to earn a high return on invested capital means that the company's earnings that are not paid out as dividends are retained by the business and are reinvested. This reinvested capital at attractive rates of return compounds into future earnings and equity growth.

- *A business with pricing flexibility*. A great business is able to maintain pricing flexibility with little competition. In doing so, these rare business who possess pricing flexibility can offer an important hedge against inflation.

- *Free cash flow*. An investor must discriminate between reported earnings and free cash flow. Many companies are forced to reinvest a large portion of earnings back into the business merely to maintain plant and equipment in order to preserve current earnings. Free cash flow represents cash earnings which are truly available for investment in additional productive assets, or for payment to stockholders.

- *Valuation*. Although many academics represent risk in terms of price volatility, we believe true risk remains the possible permanent destruction of investor capital. When investing in stocks, risk is never eliminated altogether but is materially reduced by abiding by Benjamin Graham's simple goal: Always invest at a significant discount to intrinsic value. While it is relatively easy to identify outstanding businesses, it is far more difficult for an investor to select those businesses which can be bought at significant discounts from their true underlying value. Price, and patience, is the key.

The market's daily price movements mean nothing. These daily price movements are random, meaningless events. How an investor reacts to those random events is what is important. If one lets the market's daily price swings scare him into selling, or tempt him into buying, he is lost. If an investor can ignore the market's daily noise and continue accumulating the stocks of safe and sound business at attractive valuations, he has a much higher probability of compounding capital. In other words, at St. James, we believe that the best reaction to daily stock price movements is no reaction at all.