Castle Investment Management

Portfolio Manager Commentary

St. James Investment Company
Sub-Advisor to the Fund

Castle Focus Fund

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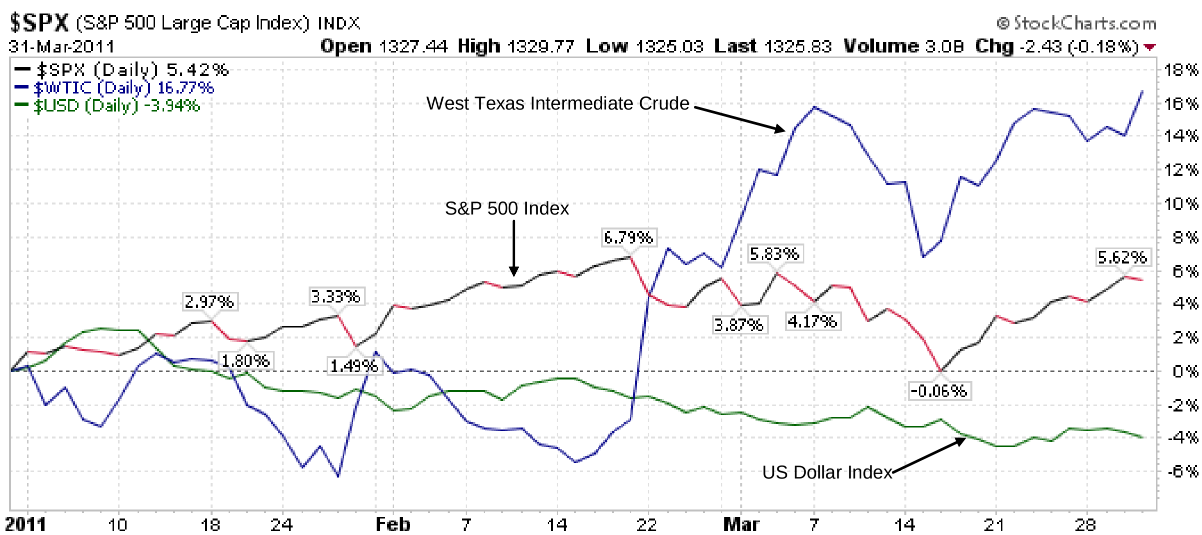
FIRST QUARTER LETTER

MARKET COMMENTS

Despite several unexpected shocks during the first quarter, the financial markets pushed higher along with growing optimism that the recovery from the financial crisis had become self-sustaining. The markets quickly discounted the political turmoil in North Africa, the Middle East and the devastating earthquake and nuclear crisis in Japan. The Dow Jones Industrial Average rose 7.1% during its best first quarter in 12 years. The Standard & Poor's 500-stock index rose by 5.9%. Reflecting investors' willingness to take on risk, small-company stocks, as measured by the Russell 2000 Index, gained 7.9% and ended the quarter slightly off its record high hit in July 2007.

Perhaps less noticed, oil prices jumped by 16% and the U.S. dollar index decreased by 4%. Yes, the equity markets posted another strong quarter in nominal terms, but barely outpaced the loss of the dollar's buying power and certainly lagged the increased costs carried by higher oil prices. Naturally, the Federal Reserve is telling Americans not to worry. According to a report from Bloomberg, Federal Reserve officials believe that the economy is on a "firmer footing, and overall conditions in the labor market appear to be improving gradually." The report concluded that while commodity prices have "risen significantly," inflation expectations have "remained stable."

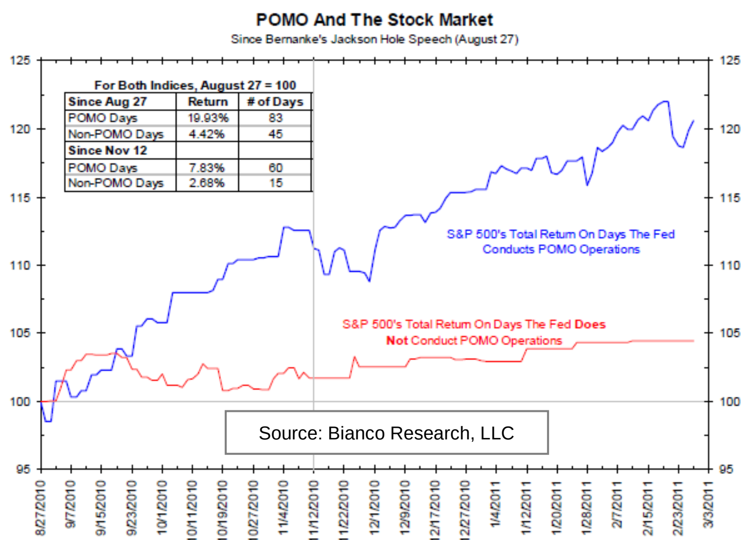


Yes, the economy is on a firmer footing. Retail sales reports show that consumers are heading back to the stores, as recent sales figures show the biggest rise in months. Unfortunately, unemployment is still "elevated" (about 10% of the labor force is out of work), houses are still being foreclosed and home prices are still going down. The Michigan consumer sentiment index has dropped to 68 – only 4 points above the low it set after Lehman went bankrupt. How is it possible that people who have no jobs and whose main asset is falling in value can still spend more money? One explanation may be the Federal Reserve's current program of quantitative easing (QE) which creates $4 billion per day. The Fed's efforts cause stock prices to go up, consumers feel wealthier and therefore they spend more. A Federal Reserve report also shows a modest rise in consumer credit – the first increase since 2008. Savings rates are also on the decline again. But here's another explanation: People are able to spend more because they are defaulting on their mortgages. More than one in ten mortgages is not being paid. That frees an enormous amount of money for other purposes, but does not constitute the sustainable economic growth that the Fed describes as "firmer footing."

The Federal Reserve is counting on a real recovery so it can remove its measure of quantitative easing. If the Fed removes its QE program – now scheduled to expire in June – the economy may falter. Officials adamantly deny that the Fed is "printing money" and causing inflation. The Federal Reserve may not be really "printing" money, but it is certainly monetizing debt, which is one of three basic ways that 'money' is created in our fiat monetary system. The other two ways that money is created include: (1) the Treasury may issue debt to support government expenditures which the markets accept through the Primary Dealers and the Federal Reserve System or (2) banks and other financial institutions expand the available money supply through credit facilities, thus expansion based upon fractional reserve lending.

But how does one define inflation? Inflation can mean many things to many people, including a simple supply-demand imbalance, such as a general slump in demand due to business cycle fluctuation. But what is most problematic is a true monetary inflation where the supply of money is expanding in excess of productive uses for that money and the organic growth of relatively riskless credit. If the Fed were to hypothetically double its balance sheet again tomorrow by buying stocks at a multiple of their closing price today, this would represent monetary inflation. And yet we are currently creating four or five dollars in a broad money supply for each new dollar in real GDP -- something is very wrong.

A productive economy requires labor, management, investment and the efficient allocation of these resources. Despite the enormous powers bestowed upon the Federal Reserve, they cannot create a productive economy by force, as there are simply too many unintended consequences. In a recent speech at the Colorado CFA Society, the Federal Reserve's Thomas Hoenig admitted that their "policies encourage speculation and don't allow for price discovery, and consequently they lead to imbalances, unintended consequences, and misallocation of resources. Therefore, it is important to judge QE2's success over the right time frame, one long enough to encompass not just its stimulative benefits but also its consequences."



One unintended consequence of the Federal Reserve's policies may be that on POMO days (permanent open market operations, a tool to implement QE2), the stock market rises. The Federal Reserve adds liquidity through the POMO facility, and that newly created 'hot money' chases beta (higher risk returns) in the markets. This is clearly not the intended process behind the efficient allocation of capital assets.

Then again, perhaps the Federal Reserve's current policy of QE is intended to target the stock market. Ben Bernanke, Chairman of the Federal Reserve, wrote a letter to the Washington Post on November 4, 2010, in which he defended the Fed's actions:

This approach eased financial conditions in the past and, so far, looks to be effective again. Stock prices rose and long-term interest rates fell when investors began to anticipate the most recent action. Easier financial conditions will promote economic growth. For example, lower mortgage rates will make housing more affordable and allow more homeowners to refinance. Lower corporate bond rates will encourage investment. <u>And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion</u>.

Manipulating stock prices higher in hopes that stock prices alone will change beliefs (increase confidence) and behavior (increase spending) is not healthy. We would rather hear Bernanke say that he is trying to improve the economy, which in turn will support higher valuations. Unfortunately, the Federal Reserve's policies have driven financial assets to rich valuations with low prospective future returns; however, any return can compete sufficiently with zero interest rates. When the main source of "prosperity" is the policy-induced elevation of asset prices - rather than the allocation of savings into productive investment - it helps to remember that present gratification often equates to future unpleasantness.

As investors, our main challenge is to always question the consensus. Financial history is full of manias and crashes that only come about when many people drink from the same bottle. It is impossible to time the reactions of the crowd, but it is wise to consider the opposite of what appears probable. In our opinion, the biggest risk to the market would be an unexpected burst of inflation. As today's interest rates reflect little thought of inflation, such unanticipated inflation would force the Fed to tighten its monetary policies in a market that is highly leveraged. An environment of increasing interest rates and high leverage is not ideal for financial assets.

Again, it goes back to our earlier question – how does one define inflation? New York Federal Reserve Chief William Dudley, a former economist for Goldman Sachs, recently explained the Federal Reserve's policies to an audience in Queens, New York. The details of the meeting were widely reported by Reuters. Dudley explained that inflation was not a problem but he was interrupted by a question from the audience:

"When was the last time, sir, that you went grocery shopping?"

Dudley responded by explaining the concept of "core CPI" -- the cost-of-living measure which excludes food and energy. Dudley pointed to Apple's new iPad2 to illustrate his point.

"Today you can buy an iPad2 that costs the same as an iPad1 that is twice as powerful. You have to look at the prices of all things."

"I can't eat an iPad," someone yelled from the audience.

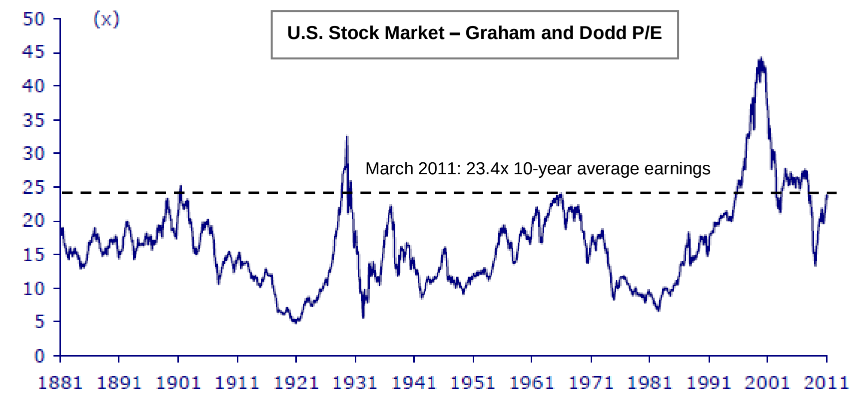
VALUATION

For investors, valuation is the closest thing to the law of gravity, as <u>value is the primary determinant of long-term returns</u>. Jeremy Grantham once wrote that while "value is a weak force in any single year; it becomes a monster over several years." We agree -- but like inflation, the definition of value is in the eye of the beholder.

In January, Goldman Sachs held its global strategy conference in London. Goldman believes that global economic growth will be stronger than expected this year, inflation will stay low and investors in U.S. equities will earn returns of 15-20%. Why? Goldman explained that consumer spending will grow by 3.5% as unemployment falls while businesses will improve their profit margins, even as commodity prices rise, because demand from the emerging economies will continue to grow. Goldman's only reference to valuation was that equities are cheap relative to the risk premium over government bonds.

Relative valuation holds little appeal to us. We prefer to value the absolute merits of each investment opportunity independently. Value is absolute – value is not relative. When valuing any asset, an investor always wants a stable anchor from which to judge the attractiveness of that investment. For instance, one of the reasons that the Graham and Dodd P/E (current prices divided by 10-year average earnings) works well as a barometer of valuation is the slow, stable growth of 10-year earnings.

The current Graham and Dodd P/E is near the upper end of its historical range. In fact, between 1881 and 1995, this P/E ratio was above the current level for just 24 months. Then, from 1995 to 2008, equities were almost always above the current level. Is the market "cheap" relative to recent history but expensive on an absolute basis? If so, is that reason enough to aggressively bid equities higher? Needless to say, you will never find a Graham and Dodd P/E graph in a Goldman Sachs presentation. Wall Street thrives on the relative – not the absolute.



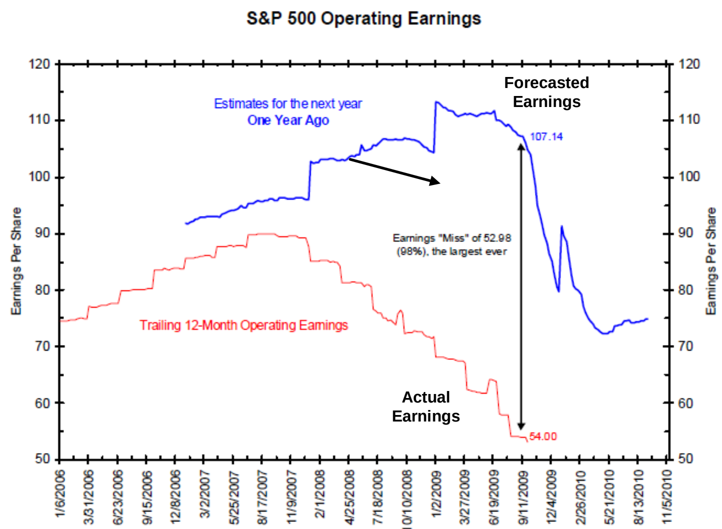
Source: Robert Shiller

Leon Cooperman, the well-known chairman of hedge fund manager Omega Advisors, recently spoke at a conference sponsored by Strategas, an institutional broker-dealer. Mr. Cooperman said that Treasurys "are screaming to be shorted." Naturally, in the relative world of Wall Street, that leaves only stocks for investors. "At worst, stocks are the best house in a bad neighborhood." Stocks "are cheap relative to history, they're cheap relative to inflation, and they're cheap relative to interest rates." Mr. Cooperman' justifications for stocks are all relative.

S&P 500 Reported Earnings			
2010	2010	2010	2010
Q1A	Q2A	Q3A	Q4E
$ 17.82	$ 19.98	$ 19.82	$ 20.94
Current price of S&P 500			1330
Trailing one year reported earnings			$ 78.57
Current Price / Earnings ratio			16.9

Again, valuation is in the eye of the beholder. FactSet Research claims that stocks are trading at a price equivalent to 13 times earnings. We verified FactSet's number with data from Standard & Poor's, the company that actually maintains the data behind the S&P 500 Index. We determined that U.S. stocks are actually trading at almost 17 times reported earnings. FactSet's claim of 13 times earnings is based on 2011's estimates of operating earnings. Standard & Poor's compiles a bottom up analyst estimate of $96.65 for 2011 – hence, FactSet's claim that they are trading at 13 times earnings (1330 ÷ $96.65 = 13.8). Wall Street often recommends stocks to investors based on analyst estimates of the operating earnings expected over the coming year, but an investor must recognize that these estimates are lowered over the course of the year. In contrast to reported earnings, operating earnings exclude numerous charges, including so-called "extraordinary" and "non-recurring" losses, even when these charges are clearly ordinary and recurring aspects of the business.

As highlighted in the nearby chart, the error between forecasted operating earnings and trailing reported earnings can become quite egregious at times. No other period has ever come close to the current period. Historically, the actual reported net earnings of the S&P 500 have averaged only about 72% of one-year forward operating earnings estimates by Wall Street analysts. All long-term investors should keep in mind that stocks are not a claim on "forward operating earnings" but rather they are a claim on a very long-term stream of future cash flows that will actually be delivered to investors as dividends, or retained on their behalf by the company as an increment to the book value.



INVESTMENT PHILOSOPHY

"Genius is nothing but a great aptitude for patience." - George-Louis de Buffon

For Benjamin Graham, value is everything and price eventually reflects value. Value investing can be described as the process of discovering and purchasing mispriced securities, then holding the securities until they approach their intrinsic value. The process is deceptively simple in theory but difficult in practice because patience is a human trait that is often in short supply. One of Jessie Livermore's best quotes expresses the necessity of patience in regard to investing most eloquently: *"Throughout all my years of investing I've found that the big money was never made in the buying or the selling. The big money was made in the waiting."*

Consider Wal-Mart (5.18% of fund assets at 3/31/11), which operates 8,986 retail outlets in 15 countries. Sam Walton originally founded the company in 1962 based on the idea of bringing big-city discounting to the rural South. To make up for low profit margins, the company had to sell higher volumes though lots of big stores. Wal-Mart lowered costs by dealing directly with manufacturers, investing in technology and logistics, and increasing work productivity, while keeping labor costs low. Sam Walton's business strategy essentially remains in place today with "everyday low prices" as the corporate motto. Unlike the Federal Reserve, Wal-Mart does not implement its business policies through the management of interest rates but rather with an extraordinary supply-chain management process. The company achieves its goal of everyday low prices through a relentless focus on improving productivity and driving operating efficiencies throughout their enormous base of invested capital and assets. Discount retailing is all about keeping gross margins flat but delivering profits through volume growth and cost structure efficiencies.

Once upon a time, Wal-Mart was a growth stock darling. Between 1980 and 2000, company revenues grew at a compounded annual rate of 28%. When domestic revenue growth slowed, the company accelerated its international growth ambitions. To-date, international growth has not yet outpaced the decline of domestic growth—consequently; Wal-Mart is now a former growth stock and treated accordingly by an impatient market.

Net Sales by Operating Segment (in Millions)											
	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**CAGR**
Wal-Mart U.S.	108,721	121,889	139,131	157,120	174,220	191,826	209,910	226,294	238,915	255,348	258,229	9.0%
International	22,728	32,100	35,485	40,794	47,572	52,543	59,237	77,116	90,570	98,840	100,107	16.0%
Sam's Club	24,801	26,798	29,395	31,702	34,537	37,119	39,798	41,582	44,336	46,899	46,710	6.5%
Total Net Sales	156,250	180,787	204,011	229,616	256,329	281,488	308,945	344,992	373,821	401,087	405,046	10.0%
Source: Company SEC Filings												

In 2000, Wal-Mart's stock traded near $60 per share with a market capitalization of $268 billion. Today, the company's stock trades closer to $50 per share and sports a market capitalization of $185 billion, yielding 2.8% based on the most recently quarterly dividend annualized. Whereas an investor once owned a fractional share of an operating company that produced $2.05 in earnings and traded at a price-to-earnings multiple of 30 times earnings in 2000, today this same investor now owns an interest in an entity that earns $4.05 per share in 2010 and trades at a multiple of 12.8 times earnings—the lowest P/E ratio in well over two decades.

Other than share price, there is little an investor can complain about regarding company fundamentals. Since year-end 2000, on a per share basis, the company's sales, cash flow, earnings, dividends and book value have grown at annual compound rates of 12.5%, 13.5%, 13.0%, 19.5% and 13.5%, respectively. Even though interest rates have collapsed over this period, the earnings multiple has as well. Such is the fate of a former growth stock darling.

Those who purchased Wal-Mart in 2000 overpaid on the hopes that its spectacular growth would return. They were wrong and have little to show today in terms of total return on their investment for the past ten years. An investment today may be different. Today an investor has the opportunity to acquire a fractional ownership of a quality company that reflects minimal prospects for future growth. Is it beyond one's imagination to consider that over the next ten years a company comprised of solid assets and guided by an adaptive management could exceed market expectations?

"Observation over many years has taught us that the chief losses to investors come from the purchase of low-quality securities at times of favorable business conditions." —Benjamin Graham, *The Intelligent Investor*

Perhaps Wal-Mart represents the purchase of a high quality security at an unfavorable time of business conditions. We believe that adhering to a value approach will tend to lead us to be a contrarian by nature. We are interested in buying when others are selling and assets are cheap just as we want to be selling when others are buying and assets are expensive.