Fellow Investors,

Investments allocated April 2009 or earlier are showing strong returns, while more recent investments are underperforming the general stock market. Since my oft-stated aim is the long-term outperformance of the stock market, some of these results are disappointing. My crystal ball which predicts short-term price movements is about as good as my vision (which is to say: very, very bad). In this letter, I want to convey two primary points. First, I want to explain again my investment style along with the positives and negatives of that style, and why that style necessitates sometimes waiting in cash. And second, I want to discuss the reasons I'm having a hard time finding good investments, which is the economic headwinds that will happen when the stimulus recedes.

Buffett on "Fat Pitch" Investments

My investment style is to only swing at the "fat pitch," a style that I've stolen rather shamelessly from Warren Buffett. In his 1997 annual letter, he analogized his investment philosophy to baseball; he explains that the difference between hall-of-fame batter Ted Williams and one with a "ticket to the minors" was the player's ability to wait for the "fat pitch" right in his strike zone. He concludes by relating this to his investments:

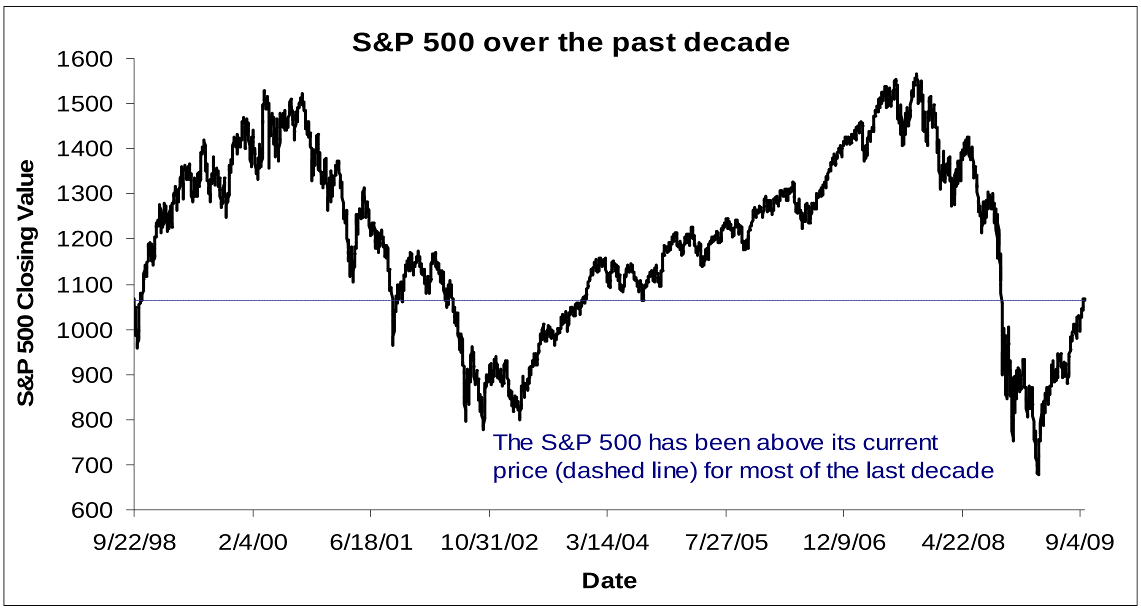
> *If they are in the strike zone at all, the business "pitches" we now see are just catching the lower outside corner. If we swing, we will be locked into low returns… Unlike Ted, we can't be called out if we resist three pitches that are barely in the strike zone; nevertheless, just standing there, day after day, with my bat on my shoulder is not my idea of fun.*

When I left Google to start this company in January, economic panic was rampant and palpable, and – my goodness – there were all sorts of fat pitches. I wanted to help you choose from an abundance of high-quality, under-priced investments available at the time. Over a few months this summer, the market went up by a torrid 60%, and those under-priced investments became fairly or even over-priced. I will later give the example of CarMax which crashed to a cheap price, but by today is at an expensive price. I've been standing with my bat on my shoulder for the last few months waiting and ready but generally unable to find pitches in my strike zone. Not my idea of fun (or profit!) either.

I am not a patient person. Twenty minutes into traffic and my fingers are drumming; sixty minutes in, and I'm mumbling to myself (ask my wife). So waiting for months for a fat pitch simply isn't my nature. I've disciplined myself to do exactly that, because I view the long-term results as being compelling. In the midst of our present crisis, financial companies of all types – hedge funds, mutual funds, investment banks, and commercial banks – collapsed; meanwhile I was starting a new financial company. When most of the world was worrying about their employment or their retirement, I was happily snapping up all sorts of companies. Surviving money managers said, absurdly, that they had done well because they'd lost a mere 35%. I'm not allowed to reveal my personal returns, but it's clear that I would not be in a financial position to quit my job if my returns were anywhere near the market's returns, and if the IRS handed out gold stars, I'd be eligible for a few. I paid more taxes this year than ever before.

So what's the negative? Why do so few money managers follow this discipline if Buffett recommends it? Simple: because there are long stretches of time when their customers are watching *everyone else* make money. Buffett, for example, wrote that piece in 1997, and was complaining about market valuations through 2000. Most money managers would lose all their clients before they could even be proven right. Over here, I will exercise the fat pitch discipline *even if* it means losing clients. I strongly believe that over the long term, it has and will lead to superior results, and will continue to invest all of our family's wealth accordingly.

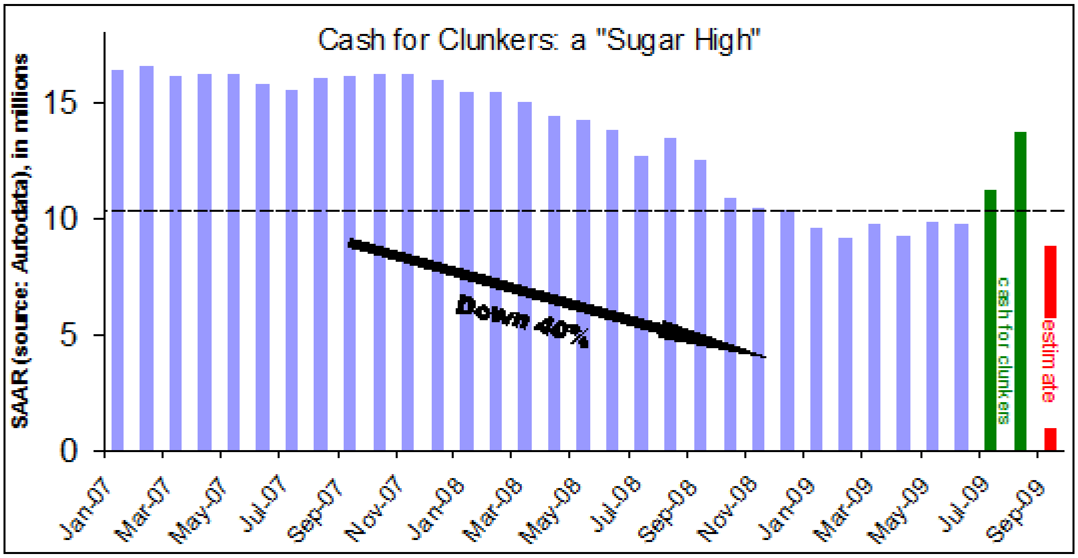
By the way, the graph below shows the S&P 500 over the past decade. It is like a Macbeth soliloquy: full of sound and fury, signifying nothing. Even though there were several stretches of intense excitement, the average market participant is probably about break-even. Random or regular purchases probably did just as poorly, because most of those purchases would now be at a loss. You can look pretty hard, but you will find that most funds 'follow the crowd' and their returns for better or worse look very much like this graph.



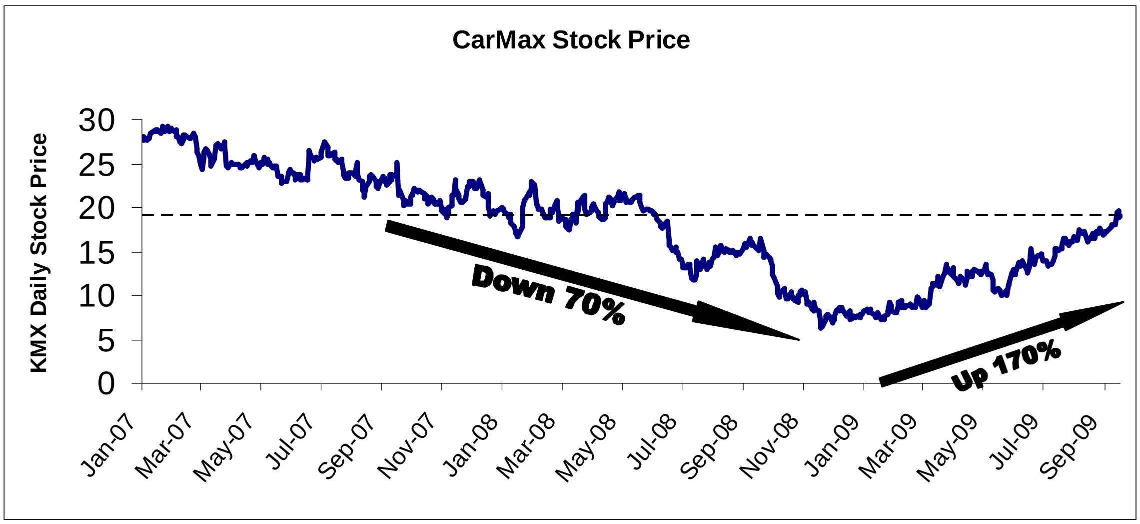
The Cash for Clunkers Parable

The general reason that finding good investments is so difficult today is my belief that most of the economic "good news" (really more like "less-bad news" or "slowing-of-the-rate-of-bad-news") is a result of heavy spending from the government that will eventually flatten, and then go into reverse. The majority of stocks I look at seem to be pricing in strong economic growth from here, but that growth is going to face the obstacle of the withdrawal of stimulus funds and other extraordinary government measures.

Below, I've graphed light vehicle sales over the past few years. From the averages in 2007, light vehicle sales dropped around 40% to their trough earlier this year, quite a severe drop. Cash for clunkers (green bars) brought July and August way up – to around 2008 levels, but nowhere near 2007 levels. After the stimulus ended in September (red line), Edmund's estimated September sales the lowest since … well, before some of you were born. The stimulus created demand, but that demand has been borrowed from the future and you can expect auto sales to be lower going forward than they would have been absent the stimulus. Even at their sugar-high best, car sales never approached pre-recession levels.



Investing, however, is all about value: even if auto sales are down, if auto sellers can be bought cheaply enough – the stock might still be a good buy. I've graphed CarMax's stock price below. In the same period that actual car sales were down by 40%, CarMax's stock price down was crashing even faster – down 70%. At the price of $5, a value investor might consider explore the stock – CarMax is a good brand, and it already seemed at that point that car sales had bottomed out. Since then, however, it's gone up a scorching 170%. The stock price is now at the level of the stock pre-crash – but there is little evidence that ongoing sales over the next few years will look anything like the pre-crash levels. Some investors think differently: $300 million of the shares were bought today, and they are welcome to it. That's not a bet I would make, at today's prices you'd have to be very optimistic about future car sales to buy the stock.



Cash for Clunkers cost the taxpayer around $3 billion. As an investor, I'm worried about the effects when the much larger stimulus package ends - $787 billion. Recently, the Council of Economic Advisors estimated that the stimulus will be responsible for 3% of the growth in the third quarter. Eventually, like with cash for clunkers, the absence of that stimulus will cause a reciprocal 3% drag on the economy. That's a pretty substantial headwind, especially with the ongoing headwind of higher unemployment, decreased consumer credit and likely higher mortgage rates.

I know of three other people whose investment successes have led them to creating their own financial companies recently. We each have our own styles, outlooks, and areas of expertise, and I can tell you they independently have been holding on to large amounts of cash – because, like me, they are finding it increasingly difficult to find fat pitches. Patience and discipline, I believe, are the real keys to long-term investing success, and that necessitates letting a lot of pitches fly on by.