Quarterly Investor's Letter
Q3-2010

Dear Fellow Investors,

Last quarter's letter focused on my response to the market drop in Q2 and a few of my investments from that quarter. I also talked about how I was reserving some cash: great opportunities were lacking and I was hoping for better prices in the future.

This quarter, my hopes were fulfilled and I'm happy to report that I've finally deployed our remaining cash into the market. With cash earning virtually no interest, it's a great feeling to finally allocate it to a good long-term investment. I'll use the rest of this letter to describe some of our largest market positions.

The most important stock addition for this quarter is one I'd been watching for over a year: Wells Fargo (WFC). WFC recently fell to its lowest price since the financial crisis began on fears of a double-dip recession and a potential decline in housing prices. I don't know whether those fears over the economy will come true. But, I believe Wells Fargo will do well in the long run *regardless* of the short-term state of the economy. You're in good company: during the financial crisis, Warren Buffett said, "If I had to put all of my net worth into stock, that [Wells Fargo] would be the stock." On the next page, I will elaborate on why Wells Fargo is a superior bank in both good and bad economic times.

I'm also including a more detailed piece about NRG, another large holding of ours. NRG's share price has fallen, which has dragged down our portfolio's performance. I personally have plenty of money in NRG and as a multiple-year holding, its current stock price does not worry me. However, I am including more details below on the economics of the industry (currently poor but improving) and how NRG has taken advantage of the current downturn to improve the company's value (as distinct from its stock price).

Our three largest holdings – Wells Fargo, NRG, and Noble Corporation (the offshore driller I described last quarter) – share a common theme: all are in industries that are under stress: the financial crisis (Wells Fargo), a sharp drop in electricity prices (NRG), and the gulf oil-spill disaster (Noble Corporation). Each was prudently managed during boom times. When turmoil struck, they were – and are, today – in a position to push out or acquire weak competitors, and grow while others are struggling.

Our company's stock prices will likely fluctuate up and down in the short-term, but as long as they keep taking advantage of industry weakness, their long-term value should increase. I'm pretty content with our current portfolio, so don't expect substantial changes in it over the coming months.

Until next time!
Kai Shih

Wells Fargo (WFC)

Wells Fargo has long been a Buffett favorite, and I've been waiting for over a year for it to come to an acceptable price. When it fell to its lowest price in a year, I snapped up shares for us.

What sets WFC apart from hundreds of other publicly-traded banks? In my mind, three things: they've figured out how to become a quasi banking in select markets; they understand how to make more money per deposit than other banks; and, they bought Wachovia during the financial crisis and are embedding it with the above two characteristics.

Wells Fargo has figured out how to lock both retail and commercial customers into their bank: they encourage customers to rely on Wells for all their financial needs. An average customer might walk in wanting only a savings account, but within 2 years, they'll have around 5 Wells Fargo products – for example, a credit card, a mortgage, a checking account, and financial planning. After 10 years, the average customer will have around 9 products. Wells is the industry leader in cross-selling new products. The result of this is two-fold: their customers find it increasingly difficult to leave the bank, since all the interlinked accounts make it most convenient to stay. And, Wells keeps increasing their revenues per customer as each customer gets more and more products. An investor acquaintance of mine summed it up: "There are no monopolies in banking, but Wells is as close as it gets."

A bank makes money by taking your deposit and lending it out, and Wells is exemplary on both counts. Perhaps due to their quasi-monopoly status, they are able to pay virtually nothing on their deposits – around 0.3%, an industry low. They lend that money out for around 4.6% interest. The difference between the rates they lend and borrow, 4.3%, is about a percent higher than their competitors. A percent might not sound like a lot, but with a deposit base of $700 billion, it means about $7 billion in extra earnings per year over an equal-sized competitor. In addition, Wells gets industry-high revenues from fee-based charges – financial planning, mortgage servicing, ATM fees, and so forth – that tend to be less economically sensitive. Wells has maintained these assorted best-in-industry metrics for many years and it means that a dollar or a customer in the hands of Wells will generate more profit than virtually any other bank. As a thrifty investor, I'm glad to invest in them, but I'll never deposit a dime with them.

During the height of the financial crisis, Wells bought Wachovia – at the time, a comparably-sized bank – for around $15 billion. Wachovia's stock price had fallen dramatically because they owned billions in problem mortgages (the kind that helped cause the housing bubble). Wells indicated this year that Wachovia's legacy mortgages were performing better than expected, and Wells believes that credit losses have already peaked. Since the acquisition, Wells has recorded some one-time losses due to the legacy Wachovia loans, and Wachovia integration costs; but soon those one-time impacts will take a back seat to the much higher earnings that can be generated by the combined deposit and customer base of the two banks.

Wells Fargo has long been one of the best-run banks in the industry; with the addition of Wachovia they are also one of the largest. As the newest addition to our portfolio, I'm thrilled to have gotten such a good company at a good price.

Banking metrics relating to long-term profitability:

	Return on Assets (higher is better)	Net Interest Margin (higher is better)	Cost of Deposits (lower is better)
Wells Fargo	0.97%	4.27%	0.37%
Peer Average	0.49%	3.39%	0.66%

Source: Wells Fargo presentation 5/19/2010

NRG Energy (NRG)

NRG generates and sells electricity in deregulated markets. Electricity prices in those markets are low today. So low, in fact, that electric power companies do not want to build new power plants. Over the next few years, I believe electricity prices must rise in order for companies like NRG to build enough power plants to meet the growing U.S. demand for electricity.

Nearly every company in NRG's industry has suffered financially from the sharp downturn in electricity prices; NRG's metrics have mostly improved. For this quarterly letter, I'll provide an overview of electricity markets, their challenges, and why I believe ultimately they must improve. In the next quarterly letter, I'll talk about how NRG has prospered while most of their competitors have suffered.

NRG financial metrics have improved as their share price and electricity prices have declined.

	Electricity prices, Houston ($/MwH)	NRG share price	NRG EBITDA (earnings metric)	NRG FCF (cash flow metric)	NRG Share Repurchases
2007-2008	$62	~$43	$4.6 billion	$1.5 billion	14 million
2009-2010	$35	~$21	$5.1 billion	$2.1 billion	28 million

Overview of Electricity Markets

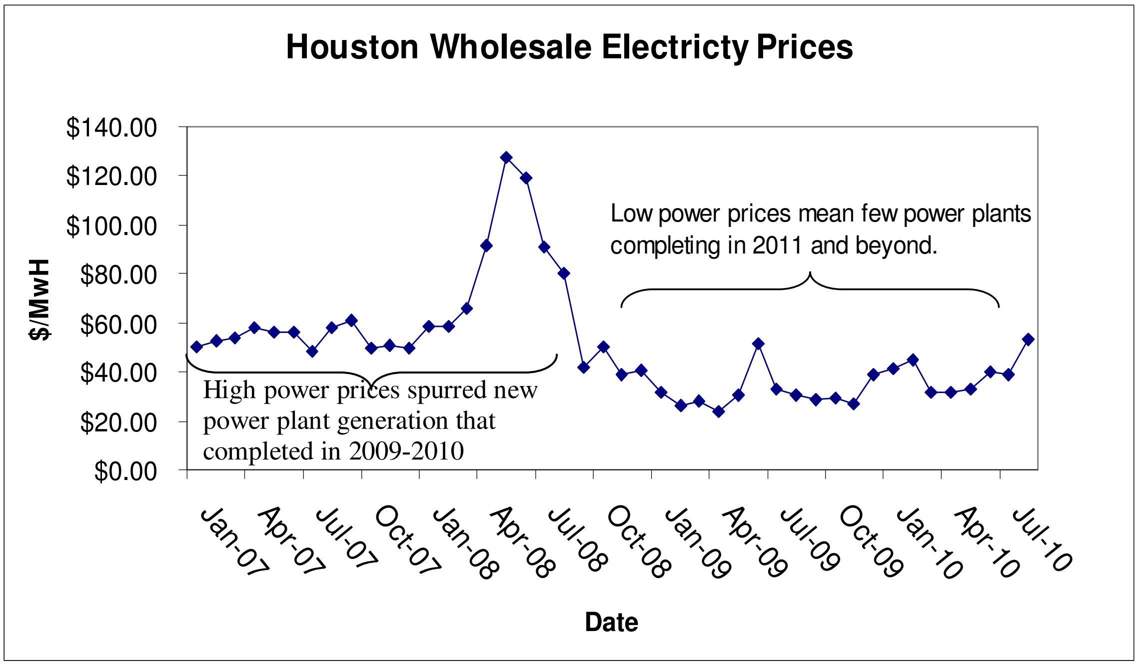
The economics of electricity are simple: everyone uses it, and demand for it increases by about 2% a year since the mid-1970's. Electricity is not easily stored in large quantities, and it can't be transported across long distances. There's no threat of Chinese or foreign competition. Power plants are expensive, time-consuming and difficult to build – particularly around population centers where they are most needed.[1]

Governments have long struggled planning the construction of enough power plants to satisfy the ever-growing demand. Historically, governments satisfied the continual need

[1] Astute readers will notice I've copied this introduction from my Q4-2009 letter in which I warned "Because NRG is a long-term, multi-year holding, I will pace myself and only write a little at a time. You're likely to lose interest in the topic far sooner than I." Consider that warning partially fulfilled.

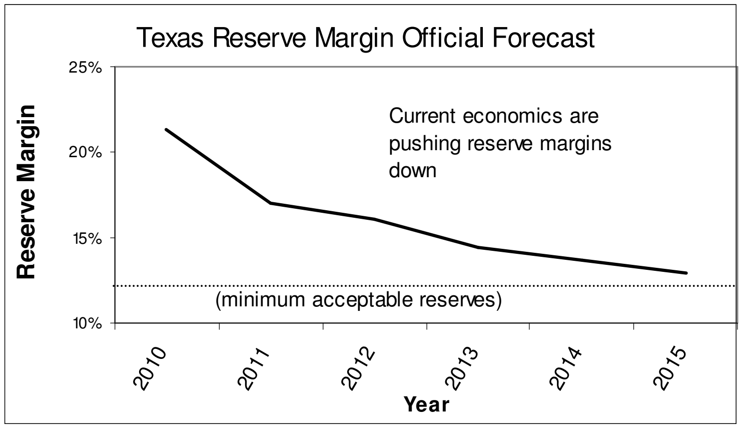
for more electrical power through central planning like utilities. But in the past decade, a few have chosen to satisfy the demand by building a market for electricity and letting private industry take care of building new plants. Below (fig 1), are the market-based prices for electricity in Houston for the past 4 years. Power prices in Houston fell by more than half between 2008 and 2009 (along with the prices of natural gas, oil, and coal) and the share prices of power companies followed suit.

Figure 1:



When power prices were high, many companies wanted to build power plants, contributing to a surplus of generation today. Conversely, because power prices today are low, old power plants are being mothballed or retired, and most companies are not interested in adding new power plants.   The power industry uses a statistic called the reserve margin to measure the amount that supplies exceed generation. Figure 2 shows Texas' official reserve margin forecast. Currently Texas has a surplus of electricity – about 20% more generation than current demand (this statistic is called the reserve margin). The outlook is for the reserve margin to decline every year through 2015 when it hits the minimum level of 12.5% allowed by the Texas legislature.   If current low power prices persist, the reserve margin curve could be pushed down faster than shown, as even more old plants are mothballed and new plants are not built.

Figure 2: Economics are pushing Texas reserve margins towards their minimum acceptable levels.



I have no idea where short-term power prices are headed – it depends on the weather, power plant outages, and the day of the week. The long-term is easier for me. Existing power plants need a certain level of profits to remain operating; new power plants need a suitable return before companies will make the necessary huge investments in new construction. Both of those factors point to higher power prices over the long-term. Demand cannot keep growing faster than supply for very long before the economics of the industry improve.

In the next quarterly letter, I'll talk specifically about NRG, which has bucked the industry by showing increasing profits, cash flow and share repurchases. They've done remarkably well on their financial metrics – better than even I expected. Value investors, like Buffett, often talk about a company's *value* being different from their stock *price*. In my opinion, NRG is an excellent example of a company that has been able to increase its long term value even as their stock price has decreased.