Year-End Investor's Letter 2010

Fellow Investors,

2010 was a year full of investment uncertainties. Among other events, the European Union nearly triggered a second economic breakdown; the US at times seemed on the verge of a double-dip recession; various domestic events like the BP oil spill and mortgage investigations caused stocks to move wildly and any of these could have caused serious harm to the economy. I adopted a somewhat defensive posture, meaning that your portfolio had a muted response to the market's swings, both up and down.
As the market swung upward in the last quarter, that defensive posture yielded returns that were shy of my expectations in my personal account as well as some of yours.

Looking over the assorted investments this year, most have had adequate to good returns. The real drag on performance has been a large investment in NRG, which has fallen over the last year. NRG's financial results were excellent both in 2009 and 2010; its price has fallen largely because of a perception that low electricity prices will continue indefinitely and increasingly harm the company's prospects. I continue to think the market is mispricing NRG's stock and I will discuss the company further on the following pages.

Every little percent of returns represents a fair amount of money to me, so I found 2010's results a bit disappointing. If I thought a different manager or strategy would return even a percent more over the long haul, I would move my personal accounts and advise you to do the same. So far my job is safe, but I will let you know if my opinion changes. If you feel disappointed with your results, give me a call and we can discuss whether my management style fits your needs.

Have a great new year!

Kai Shih

Here is a brief summary of the investments that are held in the majority of your portfolios. As always, feel free to call me (or grill me) on these or any other investments you hold.

- Wells Fargo (WFC) dropped early in the quarter due to industry-wide concerns over foreclosure practices and potential lawsuits involving former mortgages that the banks created and sold. Wells is less exposed to these types of issues than their peers, and by the end of the quarter, WFC shares had recovered (and then some). Of our major holdings, WFC is currently the one I would sell first if other opportunities should arise.

- Noble Corporation (NE), the offshore driller, continues to suffer from the drilling moratorium in the Gulf of Mexico. I'd expect the stock to move erratically during the moratorium but ultimately increase when it is lifted. Another value investor and friend of mine nicely summed up the situation: "Noble to me is a classic example of high uncertainty for the short-term market, but low uncertainty over the long term and in reality. It's just not conceivable that rig demand doesn't come back strong, even in the Gulf of Mexico."

- NRG Energy (NRG) – I've written more details on the following page. This past quarter, they continued their torrid pace of activity, acquiring the Green Mountain Energy company and a large natural gas plant, launching an electric vehicle network in Texas, and starting construction on several of the largest solar plants in the US.

NRG

Because NRG has been such a significant influence on all of our portfolios and because it was a bit of a drag for all of us in both Q4 and over the past year, I'd like to take a few paragraphs to elaborate on its situation and potential.

Let's look at NRG's strategy over the past several years. When power prices were very high a few years ago, NRG sold contracts for power extending all the way through 2012. They weren't too greedy, held on to their cash, and behaved conservatively. Then, as power prices crashed, they acquired aggressively – a strategy only possible due to low electricity prices. And even now, they're still sitting on plenty of cash to acquire more assets and companies.

What kind of investments and acquisitions is NRG making? Ever since electricity prices have fallen, NRG has been cherry-picking assets from troubled competitors at a rapid pace: solar, wind and natural gas plants, along with two large electricity retailers. For example, in November 2010, NRG bought a large natural gas power plant for $500 million – a plant that was constructed in 2003 for at least double that price. NRG has also been a large investor in solar plants and is one of the largest solar plant developers in the US. Solar is a big theme of both federal and state governments and the incentives they supply mean that NRG is getting high returns while taking little risk on the projects.

In 2010, NRG received the "global deal of the year" award from Platts (a leading energy publication) for its acquisition of Reliant Energy. The economics have been fantastic: the acquisition paid for itself in less than a year. Reliant buys electricity from generators like NRG and sells it to residential and commercial customers. The acquisition has made NRG a vertically-integrated provider of electricity in Texas and Reliant's earnings are complementary to NRG's.

The result of all these actions has been record financial performance in 2009 and 2010, in spite of low electricity prices. Low electricity prices have allowed NRG to acquire assets cheaply, and for us to acquire NRG cheaply. I'm confident electricity prices will rise eventually, and that NRG will prove to be a good investment.